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COLORADO INCOME TAX ACT OF 1964

Melvin A. Coffee

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NOTE

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COLORADO INCOME TAX ACT OF 1964

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OUTLINE

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I. SCOPE

On March 24, 1964, the Governor approved the Colorado Income Tax Act of 1964.[1] Why was this 61-page statute necessary, how did it come into being, what is its effect, what does it mean? These questions, among many others, will be asked by the members of the Colorado Department of Revenue as they prepare the new regulations[2] and as they administratively resolve issues in the examination of returns; by taxpayers as they prepare returns; by tax advisors as they assist their clients; and by the courts as they resolve disputes between the state and the taxpayer. This article is written with the hope that the nature of the statute will be better understood so that its interpretation by the public and its advisors, the administrators, and the courts will not lose sight of its reason for existence. The writer has attempted to limit this article to substantive matters which would be of general interest to most practitioners and accordingly has not discussed provisions of the Act relating to non-residents, part-year residents, banks, regulated investment

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[1] Colo. Sess. Laws 1964, ch. 95, § 1. Throughout the remainder of this article reference to the Colorado Income Tax Act of 1964 will be made to "Act, § ....."

[2] The Colorado Department of Revenue released a 156 page draft of proposed regulations during the fall of 1964. The eagerness to explain the new law is accentuated by the fact that regulations explaining the former law were last published in 1951. The draft of the proposed regulations is hereafter called the proposed regulations although the draft has not yet been formally proposed and will probably be changed before the regulations are proposed or finalized. The author wishes to emphasize that the conclusions contained herein do not necessarily represent the thinking of the Colorado Department of Revenue.

companies, real estate investment trusts, and most procedural rules. Suffice it to say that changes in these avoided areas were drafted consistent with the basic objectives and principles as discussed below.

II. BACKGROUND

The federal income tax law that we now know originated in 1913. In 1937, almost a quarter of a century later, our legislature enacted the first Colorado income tax law in a form which was substantially similar to the then existing federal law. The ensuing quarter of a century saw numerous changes in the federal law, some of which were, after a period of time, adopted as part of our local law, but many of which were never so incorporated. Congress continued to amend and our General Assembly continued to try to catch up. With the wholesale revision of the federal laws in the 1954 Internal Revenue Code[3] it became evident that this race was never to be won.

At that point it became obvious that if we continued to have a federal income tax law and a completely distinct Colorado law we would be dealing with two independent sets of complicated rules and two independent sets of interpretations, regulations, and court rulings. It cannot be denied that the federal laws have always been complicated.

A second equally complicated set of local rules is unduly burdensome[4] if the local legislature can retain the power, by local statute, to determine local revenue and to vary from the federal rules when mandatory.

Accordingly, the General Assembly in 1955 directed the Legislative Council to analyze the feasibility of relating state income tax laws and returns to the federal laws and returns.[5] In 1960, a study[6] of the Denver Chamber of Commerce renewed the momentum of a federal tie-in which had been temporarily halted by the 1959 Report of the Governor's Tax Study Group.[7] The Chamber's study provided the impetus for a joint effort by the Colorado Bar Association and

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3 For a list of some differences between federal law and the former Colorado law see, Lentz, *Pitfalls: Conflicting Requirements of the U.S. and Colorado Tax Statutes*, UNIVERSITY OF DENVER 6TH INST. ON FED. TAX 21 (1956); Hein, *Summary of Differences Between Federal and Colorado Income Taxes*, 28 COLO. CPA REPORT 3 (1963); 1 CCH COLO. TAX RPTR. 1073 (1964).

4 *But See*, FINANCING GOVERNMENT IN COLORADO, REPORT OF THE GOVERNOR'S TAX STUDY GROUP 318-320 (1959).

5 H.J. Res. 20, Colo. Sess. Laws 1955, at 960.

6 Denver Chamber of Commerce, Colorado's Problems, Its Taxes . . . Its Future, at 20-26 (1960).

7 *Supra* note 4.

the Colorado Society of Certified Public Accountants which finally persuaded the General Assembly in 1962 to submit a constitutional amendment to the electorate to permit our local statutes to be tied to federal laws.[8]

Immediately after approval[9] of the amendment in the fall of 1962, a special drafting committee, consisting of approximately thirty-five tax practitioners representing the Colorado Bar Association, the Colorado Society of Certified Public Accountants, the Trust Departments of the Denver Clearing House Association, and the Public Accountants Society of Colorado, was formed to draft a suggested statute which would implement the constitutional amendment. The committee analyzed the responses of all state departments of revenue which had already passed such conforming statutes. It weighed the suggestions for improvement contained in these responses. The committee determined to use the New York statute[10] as a guide for the taxation of individuals, partnerships, trusts, and estates and the Iowa statute for the taxation of corporations.

The entire committee was divided into five sub-groups — individual, partners and partnerships, trusts and estates, corporations, and special taxpayers (*i.e.*, banks, savings and loan associations, insurance companies, regulated investment trusts, real estate investment associations). Their charge was to determine the problems of conformity in their particular area and to propose appropriate language which would adopt the federal law as simply as possible while making provision for those minimum differences which were thought necessary for constitutional, transition from old law to new law, or limited practical reasons. The groups were told to keep the revenues as constant as possible but at the same time to discard the different Colorado treatment for accounting methods, accounting periods, definitions of inclusions, exclusions, and deductions. The sub-groups were to make no changes in the procedural law except

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8 "The general assembly may by law define the income upon which income taxes may be levied under section 17 of this article by reference to provisions of the laws of the United States in effect from time to time, whether retrospective or prospective in their operation, and shall in any such law provide the dollar amount of personal exemptions to be allowed to the taxpayer as a deduction. The general assembly may in any such law provide for other exceptions or modifications to any of such provisions of the laws of the United States and for retrospective exceptions or modifications to those provisions which are retrospective." COLO. CONST. art. X, § 19, as submitted in S. Con. Res. 2, Colo. Sess. Laws 1962, at 312.

9 SECRETARY OF STATE, ABSTRACT OF VOTES CAST 28 (1962). The vote was 231,784 for and 201,795 against.

10 See Franken, Miller, Petite, Shapiro, *Simplification of Income Tax Returns for New York State Taxpayers — Report to Senate Committee on Finance and Assembly Committee on Ways and Means*, 15 TAX L. REV. 367 (1960).

to the extent that new concepts had to be incorporated into the procedural sections.

The sub-groups reported their conclusions to the chairman of the drafting committee who then met with the sub-chairmen of these sub-groups to analyze all reports. The suggested changes were circularized and the chairman redrafted the work product of the sub-groups to make sure that the various reports and suggested revisions meshed with one another.

The redrafted work product was again circularized to the sub-chairmen, and after necessary polishing and refinishing a proposed draft was submitted to the committee of the whole which studied the bill, made its suggestions, and again repolished and refinished the language. The draft was then submitted to the council of the section of taxation for its review, comments, suggestions, and criticism. The proposed draft was repolished and revised a fourth time.

By March of 1963 the tax technicians were satisfied with their proposed draft. At that time a series of meetings was held with representatives of the Colorado Department of Revenue to get their suggestions, criticisms, and comments. I doubt if so many taxpayers' advisors and the Colorado Department of Revenue have ever in the past worked so closely and so harmoniously with each other. The results of these meetings were incorporated in the proposed statute.

On May 3, 1963, a special joint legislative interim sub-committee consisting of representatives of the House Ways and Means Committee and the Senate Finance Committee met with representatives of the drafting committee and the Department of Revenue. The proposed draft of the statute was explained and discussed. The special legislative sub-committee appointed Senator Ranger Rogers, Representatives William Griffith and Robert Eberhardt, and James Wilson of the Legislative Reference Office to work with the drafting committee and the Department of Revenue to finalize the draft and determine revenue impact of the proposed changes.

The draft was finalized and was then approved and endorsed by the Colorado Bar Association, the Colorado Society of Certified Public Accountants, and the Public Accountants Society of Colorado. That final draft was presented to the Joint Legislative Interim Study Committee which, in September of 1963, approved the proposed bill. At that point the attorneys, accountants, and trust officers requested Governor Love to call a special session of the legislature to consider the bill prior to the end of 1963. For various reasons it was determined not to call a special session but instead to consider this matter in the 1964 "short session."

House Bill No. 1003 was introduced in the House; amendments were strenuously debated and passed under the leadership of Representative William Griffith. Further changes were made in the Senate where the bill was carried by Senator Ranger Rogers. A Conference Committee resolved the differences between the two Houses. The Act, which is a product of said legislative compromise, is explained in the following sections.

III. EXPLANATION OF THE ACT

A. RESIDENT INDIVIDUALS AND ACCOUNTING RULES

1. Rates.

The rates for individuals, estates, and trusts are the same as they were under the former law. Rates vary from 3 to 8 per cent of the "Colorado taxable income."[11] A credit equal to ½ of 1 per cent continues to be allowed for so much of the "Colorado taxable income" as does not exceed $9,000.[12] The credit reduces the tax by as much as $5 in the lowest bracket and as much as $45 in the top bracket. The net effect of the credit is to change the 3 to 8 per cent structure to 2½ to 8 per cent.

2. Surtax.

The additional 2 per cent surtax continues to be applied to Colorado resident individuals whose "Colorado gross income" consists of more than $5,000 of dividends, interest, and certain related intangible income.[13] Colorado gross income is specifically defined to mean federal gross income with certain modifications.[14] Therefore, since $100 of dividends is excluded from federal gross income, if a husband and wife jointly own stock, no surtax will be due on the first $10,200 of dividends and the 2 per cent surtax will apply on any excess. If a husband and wife jointly own a bank savings account, no surtax will be due on the first $10,000 of interest and the 2 per cent surtax will apply to any excess.

This writer submits that the surtax is a discriminatory tax and should be abolished especially since its revenue impact is negligible.[15] It discriminates against residents in favor of non-residents, against holders of stock and interest-paying securities or accounts in favor of holders of other types of investments such as rented

[11] Act, § 4(2).
[12] Act, § 4(3).
[13] Act, § 6(1).
[14] Act, § 2(12).
[15] The Department of Revenue stopped tabulating these revenues when the exclusion was raised from $600.00 to $5,000.00. See Colo. Sess. Laws 1959, ch. 254 at 781.

property, against individuals who either are not in the business of receiving dividends and interest or are in such business as sole proprietors in favor of those who receive their dividends or interest through partnerships, trusts, or estates.[16]

The proponents of the new statute had more urgent problems to contend with than those which would be created had they attempted to defend the repeal of the surtax. Accordingly, they adopted the existing statute verbatim except where it was necessary to adopt new concepts such as "Colorado gross income" and "Colorado net income." We strove to keep Colorado revenues from this "discriminatory" tax constant — neither substantially increasing nor decreasing such revenues. Accordingly, it seems clear that the undistributed taxable income of Subchapter S shareholders (which is not treated as a dividend for federal purposes) should not be construed a quasi-dividend subject to the surtax.

3. *Measure.*

Federal income taxes are computed by applying the following procedures:

Step 1. Determine the measure to which the rates are applied. Gross income minus trade and business deductions[17] equals federal adjusted gross income which minus personal deductions (either standard or itemized) and minus personal exemptions equals the federal taxable income.

Step 2. Apply the rates to the measure which equals the tax liability before credits.

Step 3. Subtract credits from the tax liability which will equal the amount of federal tax to be paid.

It is apparent that the taxpayers' federal income tax bill is the end result of the inter-relationship of the tax measure, the tax rates, and the tax credits. How could the statute best tie the Colorado tax law to the federal law? Two alternatives are evident.

First, the statute could dictate that the Colorado income tax would be some percentage of the federal income tax, either before or after credits. Second, it could provide that the Colorado measure would be the federal measure and then apply Colorado rates and Colorado credits.

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[16] The dividends and interest of a sole proprietor are not reduced for this purpose by expenses incurred in generating that income whereas expenses of a partnership, trust or estate do offset the same type of income.

[17] The term "trade and business deductions" refers to all deductions allowed by INT. REV. CODE OF 1954, § 62.

The second alternative[18] was chosen for the following reasons:

(a) *State Autonomy.* State finances would be too dependent on federal law if the Colorado rate were tied to the federal rate. If Congress cut taxes substantially, as in 1964 and 1965, state revenues would be seriously jeopardized. Similarly, state taxes would go up substantially if federal taxes were raised either by broadening the federal base or increasing the federal rates. Further, Colorado legislators might believe that due to special Colorado agricultural, industrial, political, or economic conditions, specific federal rules should not be applied in our Colorado law. For example, Colorado is interested in assisting the infant oil shale industry. Federal law permits oil shale to be depleted at the rate of only 15 per cent. As we shall see, the legislature desired to grant an incentive to such industry by increasing the depletion rate to that accorded oil wells, *i.e.*, 27½ per cent. It could not have done so if we tied our tax rate to the federal rate. By using the second alternative, our state legislators retain the ultimate power to provide for different tax consequences whenever such differences are deemed imperative.

(b) *Constitutional Reasons.* It is generally believed that Colorado cannot constitutionally tax interest on federal bonds.[19] Also, because of transitional problems, an item may be taxed for federal purposes at some point in time after Colorado has already taxed it. If the statute simply tied rate to rate, Colorado would thereby tax income unconstitutionally whenever a taxpayer had federal income consisting of federal bond interest or income which had already been taxed by Colorado. Further, the constitutional amendment itself provided that the legislature would determine the value of the dependent deduction.[20] This mandate could not be accomplished if the Colorado rate were tied to the federal rate.

4. Colorado Adjusted Gross Income.

How does the statute implement the decision to tie the Colorado measure to the federal measure? The law provides that the first significant figure on the Colorado income tax return is the taxpayer's adjusted gross income from his federal return.[21] It is necessary to start with adjusted gross income instead of taxable in-

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[18] Because the Act ties measure to measure and not rate to rate, Colorado has no special rules regarding personal holding company taxes, accumulated earnings taxes, and denial of surtax exemptions to controlled corporations.

[19] See Colo. Reg. § 4(b) (1951); Macallen Company v. Massachusetts, 279 U.S. 620 (1929); 31 U.S.C.A. § 742; Annot., 100 L. Ed. 637 (1956); Annot., 99 L. Ed. 961 (1955); Annot., 94 L. Ed. 449 (1950).

[20] *Supra* note 8.

[21] Act, §§ 9(1), 10(1).

come because numerous Colorado taxpayers have adjusted gross incomes of less than $5,000 and do not itemize their personal deductions. Such taxpayers have no "taxable income" on their federal return. They figure their tax by applying, directly to their federal adjusted gross income, a federal table with a built-in standard deduction and deduction for exemptions. The last figure on their federal return representing the federal measure of income is therefore the federal adjusted gross income.

By copying the federal adjusted gross income figure on the Colorado return the statute automatically adopts all federal rules regarding the includability or excludability of income. For example, Colorado thereby automatically adopts the federal exclusion rules regarding dividends, sick pay, scholarships, and annuities and also adopts the six months holding period for long-term capital gain treatment. On the other hand, Colorado automatically adopts the federal rules concerning the non-deductibility of commuting expenses and the includability of alimony by the wife.

There are four[22] and *only* four modifications which are added to the federal adjusted gross income in arriving at Colorado adjusted gross income and there are eight[23] and *only* eight modifications which reduce federal adjusted gross income in arriving at Colorado adjusted gross income. The federal and Colorado adjusted gross incomes vary only if the difference is contemplated by one of the statutory modifications; if the difference is not contemplated by express statutory exception regardless of logic, equity, fairness, or any other principle, the federal and Colorado adjusted gross incomes are identical.[24] For example, because of old law differences it is entirely conceivable that a corporation could have accumulated earnings and profits of $100 for federal purposes, but of $100,000 for Colorado purposes. The tax definition of "dividend" is restricted to distributions from earnings and profits. Therefore, if the corporation were to distribute the $100,000 to a Colorado resident in a new law year, only $100 of that distribution would be a dividend and the remainder would first reduce basis of the stock to zero and the excess would be treated as capital gain. Were it not for the Act, the entire $100,000 would be a dividend. Similarly, if a Subchapter S corporation distributes $100,000 which was previously taxed to the Sub-chapter S shareholders pursuant to federal law in old law years,

[22] The modifications discussed here are those which are incurred directly by the resident individual. Such an individual may also have similar modifications which affect his return but are incurred directly by a partnership, estate or trust. See Act, §§ 10(4)-(5).

[23] *Ibid.*

[24] Act, § 10(1).

no portion of that distribution made in the new law year would be taxed for Colorado purposes. All of it would have been taxed as a dividend by Colorado had the distribution been made in an old law year. Also, if a short-term asset is sold for 100x in a new law year which has a Colorado basis of 60x but a federal basis of 70x, then gain for Colorado purposes will be 30x and not 40x even though, had that asset been sold in an old law year, Colorado would have taxed 40x.

Numerous additional examples could be listed, but the important concept to remember is that Colorado adjusted gross income is *identical* to the federal adjusted gross income if there is no specific statutory exception which provides for a different result.

What are those specific statutory exceptions?

(a) *Modifications which increase federal adjusted gross income.*

(1) *Certain federally-excluded state interest.*[25] Federal law excludes interest paid on certain governmental obligations, *e.g.*, municipal bonds. This modification will tax such interest as well as all other interest on obligations of any state or any political subdivision thereof which interest is excluded for federal purposes. An exception to the modification was intended[26] to state that federal adjusted gross income will not be increased by interest which is specifically exempt from income tax by other Colorado statutes.

The drafters felt that Colorado should continue to tax such federally-excluded state interest to keep revenues constant.

(2) *State income taxes deducted in arriving at federal adjusted gross income.*[27] State income taxes can be deducted either as an itemized federal deduction or, under certain circumstances, as a deduction in arriving at federal adjusted gross income. Since Colorado income taxes should not be deductible in computing Colorado taxable income, if such taxes were deducted in arriving at federal adjusted gross income, they should be added back when computing Colorado adjusted gross income. Income taxes imposed by other states and deducted on the federal return are added to federal adjusted gross income because such taxes are claimed as a credit. If the Colorado oil and gas production taxes are deducted in arriving at federal adjusted gross income, said deduction is not added back in arriving at Colorado adjusted gross income.

[25] Act, § 10(2)(a).
[26] Act, § 10(2)(a) has a misplaced comma after the word "thereof." Proposed Reg. Sec. 10(2)(a) lists such interest which is specifically exempt by Colorado Statute.
[27] Act, § 10(2)(b).

(3) *Federal net operating loss deduction.*[28] This federal deduction must be added back since Colorado has special rules for determining the operating loss deduction.[29]

(4) *Certain federal income tax refunds.*[30] Assume a taxpayer deducted federal income taxes on a prior Colorado income tax return which produced a Colorado tax benefit in that prior year. If some or all of those federal taxes are refunded (Yes, Virginia, there is a Santa Claus), the refund produces no federal income because the federal income taxes were never deductible on federal returns. Former Colorado law demanded that this federal refund be treated differently on the Colorado return and that it should be taxed. This modification continues the difference because it was felt that to do otherwise would substantially reduce state revenues.

(b) *Modifications which decrease federal adjusted gross income.*

(1) *Certain interest on federal obligations.*[31] Federal law taxes interest on federal obligations issued after September 1, 1917, with stated exceptions. It was thought necessary because of the constitutional prohibition against state taxation of federal debt to exempt all such interest income from federal obligations.[32]

(2) *Interest income on certain federal agency obligations.*[33] This section is intended to exempt interest paid by federal agencies which is subject to federal tax but which constitutionally must be free of Colorado tax. The rationale for this modification is the same as that for federal obligation interest.

(3) *Certain pension and retirement payments.*[34] Federally, *all* pensions are taxable except those relating to social security and railroad retirement. Congress enacted the retirement income credit to give other pension income similar tax-free status. Recall that the Act ties Colorado measure to federal measure and does not tie Colorado rate to federal rate. Accordingly, federal credits are not incorporated in the Act.

The Colorado modification for exclusion of certain pension and retirement payments caters to those benefits which are substantially in lieu of social security coverage, *e.g.*, state and public employees' retirement act payments, public school teachers' retirement

[28] Act, § 10(2)(c).
[29] Act, § 59, discussed at 350-51, *infra.*
[30] Act, § 10(2)(d).
[31] Act, § 10(3)(a).
[32] See note 19 *supra.*
[33] Act, § 10(3)(b).
[34] Act, § 10(3)(c).

fund payments, faculty emeritus fund payments, police and firemen's retirement benefits, and civil service retirement benefits. It is cautiously stated that this modification applies to certain retirement benefits which are "substantially" in lieu of social security coverage. In reality an employee can conceivably receive one or more of these special retirement benefits and also receive social security benefits as a result of simultaneous multiple employment or working for different kinds of employers during separate periods of the employee's productive life span. Union members receive union-negotiated pension payments in addition to social security benefits.

Theoretically, if the Colorado law exempts social security benefits, only other retirement benefits which are in lieu of and not in addition to social security should be exempt. From a practical standpoint, proponents of the Act had sufficient problems without incurring the wrath of groups representing civil service, public, state, police, fire, teaching, university, and union employees for the sake of the philosophical symmetry in the exclusion area.

(4) *Basis adjustments.*[35] As a result of former law, taxpayers can have a federal basis of property which differs from the Colorado basis for many reasons, including different depreciation methods, original acquisition which preceded March 1, 1937, or joint tenancy property acquired by the surviving joint tenant. The drafters felt that it was imperative for Colorado taxpayers to adopt the federal basis for Colorado depreciation computations in new law years regardless of the fact that the Colorado basis differs from the federal basis. The drafters also believed that the difference in Colorado and federal basis should be accounted for, if at all, only in the year of disposition of the asset.

If, in the year of sale, a taxpayer has an asset which has an adjusted basis of 80 for federal purposes but 90 for Colorado purposes and that asset is sold for 90, the federal adjusted gross income carried to the Colorado return will show a gain of 10 (the gain will be 5 if the disposition is treated for federal purposes as a long-term capital gain transaction). The modification provides that there will be no gain for Colorado purposes and therefore 10 (or 5 if the disposition produced long-term capital gain) is subtracted on the Colorado return from the federal adjusted gross income. Were it not for this modification, Colorado would be taxing capital and not income.

This adjustment is a one-way street in favor of the taxpayer. If the Colorado basis is less than the federal basis there is no in-

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[35] Act, § 10(3)(d).

creasing modification to federal adjusted gross income. This result was intentional. The drafters provided for modifications which for one reason or another they felt were mandatory. To deny a taxpayer a reducing modification would amount to an unconstitutional tax on capital. It was believed that the potential loss of revenue inherent in a case in which the Colorado basis was less than the federal basis was not sufficient to warrant complicating the law, accounting records, and tax reporting.

(5) *Annuities and amounts necessary to prevent double taxation.*[36] Former Colorado law, but not federal law, dictated that income and expenses of a decedent had to be accrued on the decedent's last return. Therefore, if a decedent had died in an old law year his personal representative would have been forced to accrue all income which was receivable but not received even though the decedent had been a cash basis taxpayer. Were the receivable collected in a new law year, the federal adjusted gross income of the recipient would include such receipt as income in respect of the decedent.[37] The adoption of federal adjusted gross income with no modification would subject such income to double taxation by Colorado.

Similarly, former Colorado law followed pre-1954 federal law regarding the taxation of annuities. Colorado law dictated that 3 per cent of the cost of an annuity was income to the recipient, whereas present federal law abandons the old 3 per cent rule and provides that only a prorated portion of the excess of the expected return over cost is income.[38] If, applying the different rules, a taxpayer had reported the following annuity income:

Year	*Colorado*	*Federal*
1960	$1,000	$ 500
1961	1,000	500
1962	1,000	500
1963	1,000	500
1964	1,000	500

he would have, as of the effective date of the Act, reported $2,500 more income to Colorado than he had on his federal return. If he were to report $500 in his 1965 federal return with no modification to reduce his federal adjusted gross income for Colorado tax purposes, he would be taxed on total Colorado annuity income, which would exceed total federal annuity income, and would be paying tax on that $500 once again. The proposed regulations state that he

[36] Act, § 10(3)(e).
[37] INT. REV. CODE OF 1954, §§ 61(a)(14), 691(a).
[38] *Id.* § 72(b).

will have a $500 modification in each of the years 1965, 1966, 1967, 1968, and 1969.

In order to prevent the constitutional objection of double taxation in situations such as those described above, the federal adjusted gross income is reduced for Colorado purposes by any item of income already taxed by Colorado under former law. This modification, just as the basis adjustment, is a one-way street in the taxpayer's favor. Again the result was intentional; the reasons for the one-sided benefit to the taxpayer discussed in relation to the basis adjustment apply with equal vigor here. Therefore, although federal adjusted gross income will be adjusted downward if we have income in respect of a decedent which was accrued pursuant to Colorado law, there is no upward adjustment provided for deductions in respect of a decedent which have been previously deducted from the decedent's former law accrual basis return.

(6) *Refunds of state income taxes.*[39] Income taxes paid to Colorado and other states are deductible on the federal return but are not deductible on the Colorado return.[40] If all or a portion of such state income taxes are subsequently refunded (Yes, Virginia, there is also a State Santa Claus.) the amounts refunded must be included in the taxpayer's federal adjusted gross income. Were it not for this modification, such state taxes although not deductible on the Colorado return when paid would be income when refunded. This would amount to double taxation by Colorado: first, paying tax on income used to pay a tax to a state and second, paying a tax on the portion of that same tax when it is refunded. Therefore, federal adjusted gross income is reduced by the amount of such refunds or credits in arriving at Colorado adjusted gross income.

(7) *Net operating loss deduction.*[41] The function of the net operating loss, hereafter called NOL, deduction is to cause the government to be a taxpayer's partner in bad times as well as good. Federal law provides that the NOL may be carried back three years prior to the loss year and carried forward five years subsequent to that loss year as a deduction which offsets ordinary income dollar for dollar.[42] The federal NOL deduction produces tax refunds from the prior years when the taxpayer was making money and further reduces future years' income in order to recoup a portion of the loss incurred in the loss year. Pursuant to former law Colorado was a somewhat restrained partner. It allowed no carryback; the carry

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39 Act, § 10(3)(f).
40 Act, §§ 10(2) b, 13(3).
41 Act, §§ 10(3)(g) and 59.
42 INT. REV. CODE OF 1954, § 172(a) and (b).

forward extended to only four years; $2,000 of the carry forward was wasted if the carry forward produced no tax benefit; and, of greatest importance, the NOL offset capital gains and only $2,000 of ordinary income in the carry forward years.

The Act permits the deduction to be used as it is federally with the following exceptions: First, a NOL will not be carried back to an old law year,[43] *e.g.*, a 1965 NOL can be carried back to no year but will be usable in 1966, 1967, 1968, 1969, and 1970; a 1966 NOL can be carried back to 1965 and carried forward through 1971; a 1967 NOL can be carried back to 1965 and 1966 and carried forward through 1972. The reason for this exception was that the drafters did not want to jeopardize past income of the state treasury received pursuant to former law. Second, if a taxpayer incurred a NOL in an old law year, the amount of the NOL and the number of carry forward years are to be determined in accordance with former law.[44] For example a NOL incurred in 1962 of $100,000 would have been carried forward in 1963 and 1964 and the unused excess will be available to offset ordinary income only in 1965 and 1966. Third, if a business has some income which is not allocated to Colorado the amount of the NOL deduction is the portion of the NOL allocated to Colorado in the year of loss.[45] If a corporation generates a $100,000 federal NOL with Colorado allocated income being $1 and non-Colorado source loss being $100,001, the Colorado NOL deduction would be zero.

(8) *Oil Shale modifications.*[46] This adjustment is the perfect example that by this Act our legislature has not surrendered its legislative power to Washington. The modification, which was not a part of the proposed bill submitted by the bar and the accountants, was enacted by the House of Representatives because it was reported (1) that our Washington representatives wanted a more liberal state tax law to convince Congress that it should liberalize the corresponding federal rules and (2) that the then unborn oil shale industry required tax assistance to ease birth pains. I must admit that this lawyer, who receives no depreciation, depletion, or intangible drilling expense type deduction for his preparation-investment, still wonders whether this difference between federal and Colorado treatment is justified. Will this adjustment truly spell the difference between oil shale life or death? Will this adjustment be the moving cause which forces such industry to come to Colorado which to-

[43] Act, § 59(2).
[44] Act, § 59(4).
[45] Act, § 59(1).
[46] Act, § 10(3)(h).

gether with Wyoming and Utah has substantially all the oil shale deposits in the United States?

The effect of the modification is to reduce federal adjusted gross income by a depletion deduction computed at 27½ per cent instead of the federal 15 per cent and to adopt as the measure to which the increased depletion rate is applied the value of the shale after it has been reduced to oil.

5. *Colorado Deduction.*

We have stated that the first significant figure on the Colorado return is the federal adjusted gross income total which is copied from the federal return. Most taxpayers' returns will be prepared with no modifications to the federal adjusted gross income and in such instances the preceding discussion has only academic interest. The "bread and butter" of the Act follows.

By incorporating federal adjusted gross income Colorado automatically adopted federal rules concerning, *inter alia,* what income is includable, what income is excludable, what trade or business deductions would be allowed, the determination of whether income or loss is ordinary or capital, holding periods, bases, and depreciation. The Colorado deduction adopts federal rules regarding the so-called "personal deductions" such as interest, medical expenses, charitable contributions, bad debts, losses, and alimony. In the Colorado adjusted gross income area we determine what, how much, and when something is income. In the Colorado deduction area we determine what, how much, and when we can deduct so-called "non-business deductions."

(a) *Colorado Standard Deduction.* The Colorado deduction[47] is claimed in one of two ways. First, the taxpayer may automatically claim the standard deduction[48] which is the sum of the federal income tax deduction discussed below and generally 10 per cent of Colorado adjusted gross income limited to $1,000 ($500 for a married taxpayer who files separately). This general rule is subject to the following exceptions:

(1) Unmarried individuals whose Colorado adjusted gross income is less than $10,000 must use a special table promulgated by the director.[49]

(2) A married individual (i) who files jointly and whose Colorado adjusted gross income is less than $10,000 must use the

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[47] Act, §§ 9(1), 11 and 13(1).
[48] Act, §§ 11, 12(1)-(2).
[49] Act, § 12(3).

special table or (ii) who files separately and has Colorado adjusted gross income of less than $10,000 must also use the table.[50]

The Act places increased emphasis on the standard deduction and de-emphasizes itemized deductions. Under former law, an individual could itemize even if he did not itemize on his federal return and further, either spouse could compel the other spouse to itemize. The Act declares that if a taxpayer does not itemize on his federal return he must use the Colorado standard deduction[51] and further dictates that either spouse can compel the other spouse to use the standard deduction.[52]

This shift in favor of the standard deduction was enacted in order to simplify the preparation and auditing of returns. Simplification results not only from the obvious fact that one standard deduction is easier to administer than composite itemized deductions but also because the Colorado itemized deduction is tied to the federal itemized deduction. If a tax payer used the federal tables or the federal standard deduction, to what would the Colorado itemized deduction be tied?

We indicated that the Colorado deduction could be claimed in two ways: by use of the Colorado standard deduction or in certain circumstances by use of the Colorado itemized deduction. If the taxpayer itemized his deductions on his corresponding federal return and, in the case of spouses who file separate returns, the taxpayer's spouse does not elect the standard deduction by use of a table or otherwise, such taxpayer may elect the Colorado itemized deduction.

(b) *Colorado Itemized Deduction.*[53] The Colorado itemized deduction is the total of his so-called federal "page 2" deductions, *e.g.*, personal interest and taxes, medical expenses, charitable contributions, alimony, etc., with certain modifications. By starting with the total of the federal itemized deductions the Act again implements

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[50] Act, § 12(2)(b) and (3). A significant drafting error possibly occurs in this section. The intent of the drafters was clearly to limit married taxpayers to a standard deduction equal to federal income taxes plus a maximum of $1,000.00 whether they file separately or jointly. The wording of Act, § 12(2)(b)(ii) unfortunately can be interpreted to provide a combined standard deduction of federal income tax plus more than $1,000.00 if husband and wife file separately and one spouse has Colorado adjusted gross income of more than $9,999.99 and the other has Colorado adjusted gross income of more than $5,000.00 and less than $10,000.00. The low income spouse might urge that she should use a table which provides a deduction in addition to federal income taxes of between $500.01 and $999.99. The Act should be amended to limit such low income spouse to federal income taxes plus a maximum of $500.00.

[51] Act, §§ 11 and 13(1).

[52] Act, §§ 11 and 13(2)(a).

[53] Act, § 13.

the decision to tie the Colorado measure to the federal measure. It automatically adopts all federal rules regarding such determinations as the type and amount of medical expenses which may be deducted, the limitations of charitable deductions, the deductibility of alimony by the payor, and the types of state and local taxes which may be deducted.

There is one and *only* one modification which reduces the federal itemized deduction total thereby increasing Colorado taxable income. There are two and *only* two modifications which increase the federal itemized deduction total thereby decreasing Colorado taxable income.

(1) *Modification reducing the total federal itemized deduction.*[54] Included in the taxpayer's federal "page 2" deductions are property, sales, gasoline, and income taxes imposed by Colorado and other state and local taxing jurisdictions. All *income* taxes imposed by Colorado or any other taxing jurisdiction which were deducted in the federal return are subtracted from the federal itemized deduction total. The Act carves out Colorado income taxes because in order to keep revenues constant it must continue to deny the deductibility of the Colorado income tax on the Colorado return. The statute denies the deductibility of other taxing jurisdictions' income taxes because such taxes reduce the Colorado tax by way of credit.[55]

(2) *Modifications increasing the total federal itemized deduction.*

(i) *Federal income tax.*[56] The federal government, just as our state government, denies the deductibility of its own income tax in computing that tax. This modification increases the total of the "page 2" deductions by the corresponding year's federal income tax liability. The computation of this federal income tax deduction is simplified by placing it on a mandatory accrual basis. The taxpayer will no longer be forced to add withholdings and estimate payments and subtract federal refunds for the year in question as he had to do under the former elective cash basis method of deducting this tax. Instead he will copy the net tax liability as shown on one line on his corresponding federal return and inscribe that single number as his federal income tax deduction.

The statute retains the former provision that to the extent the federal income tax liability is related to income which produces no income tax revenue for the State of Colorado, such portion of the

[54] Act, § 13(3).
[55] Act, § 8.
[56] Act, § 13(4)(a).

federal tax liability may not be deducted.[57] Nevertheless, the deduction is continued for federal income tax liability attributable to such items as United States interest because of the fear of taxing indirectly that which constitutionally could not be directly taxed.

The simplicity of mandatory accrual of this deduction will have a one-shot adverse effect on the fisc, although because of withholding and estimated tax payments this adverse effect should not be substantial. Taxpayers who formerly claimed federal taxes on the cash basis will be permitted to deduct on their 1965 returns to be filed in 1966 not only the accrued 1965 federal income tax liability but also amounts paid on their 1964 tax liability in the year 1965, *e.g.*, the last estimate and any additional amount paid when they filed the federal return. This will result in a bunching of deductions. The alternatives were to deny such cash basis taxpayers the transition deduction entirely or to prorate said transitional amounts which would have complicated future Colorado returns. It was determined that the transitional bunching of deductions would present the fewest net problems.

(ii) *Certain taxes claimed as credit on the federal return.*[58] If a taxpayer pays taxes to a foreign country or possession of the United States on income from sources without the United States, such payments or obligations may be claimed either as deductions or credits on the federal return.[59] If the taxpayer claimed such taxes as deductions they will reduce Colorado taxable income buried either in the federal adjusted gross income or in the federal itemized deductions. If they are claimed as a federal credit, except for this modification the taxpayer would receive no Colorado tax benefit. This results because credits are claimed after the federal measure is determined.

6. *Colorado Personal Exemptions.*[60]

The Colorado personal exemption is the last item subtracted from the Colorado adjusted gross income in order to complete the Colorado adoption of the federal measure. The exemption equals the number of federal exemptions times $750. The Act thereby adopts all federal rules regarding definitions of dependent, gross income

[57] Hopefully, the Act repudiates the clearly inequitable result of Robinson v. Colorado, 392 P.2d 606 (Colo. 1964), in which a beneficiary was disallowed approximately $33,000 of paid federal income taxes because under Colorado law that which gave rise to federal tax was deemed corpus and therefore not subject to Colorado tax at the beneficiary level although it was taxed by Colorado at the fiduciary level.

[58] Act, § 13(4)(b).

[59] INT. REV. CODE OF 1954, §§ 33, 275(a)(4) and 901.

[60] Act, §§ 9 and 14.

limitations of dependents, multiple support agreements, and dependent college students. For example, those taxpayers who formerly could deduct as a Colorado dependent an individual who had gross income of between $600.00 and $749.99 will now lose such a deduction. Those taxpayers who formerly could not deduct as a Colorado dependent an individual who was multiply supported or who was a "full-time student" will gain such a deduction.

7. *Credits.*[60a]

The Colorado tax is determined by applying the Colorado rates previously discussed to the resulting Colorado taxable income. This resulting tax is reduced by withholding or estimated tax payments and is further reduced by the credit[61] for income taxes paid to other states, the District of Columbia, and possessions of the United States. No substantive changes from former law were intended in this section.

8. *Accounting Methods and Periods.*[62]

Chaos would have resulted if the statute did not demand that the taxpayer's method and period of accounting for Colorado purposes must be the same as the federal method and period. For example, in numerous cases a taxpayer formerly used the installment method of reporting income for federal purposes but the accrual method for state purposes; the death of a partner formerly terminated a partnership's year but generally did not end the year for federal purposes. How could the Act effectively tie measure to measure without also adopting federal accounting methods and periods? The Act sets forth various transitional provisions in order to make previously diverse federal and state methods and years identical for the future.[63] The intent was to force the Colorado taxpayer to the federal method and period as soon as possible.

B. RESIDENT PARTNERS

1. *Background.*

Wholesale revisions were made in the 1954 Internal Revenue Code in the area of the taxation of partners and partnerships. Fed-

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[60a] The 1965 General Assembly added a food sales tax credit to the credits discussed in the text. The sales tax credit will be added as COLO. REV. STAT. § 138-1-18 (1963) and provides generally that resident individuals will receive an amount equal to $7.00 ($3.50 for the first taxable year ending after June 1, 1965, and before January 1, 1966) times the number of allowable personal exemptions. If said amount exceeds the tax due, Colorado will pay said excess as an overpayment.

[61] Act, § 8.

[62] Act, § 7.

[63] *Ibid.*

eral changes were made respecting contributions[64] and distributions of property,[65] transfers of partnership interests,[66] termination of partnership taxable years,[67] transactions between partnerships and partners,[68] payments to retiring or deceased partners,[69] and basis adjustments.[70] Since the Colorado law was based on the federal law as of 1937 every 1954 federal change represented at least a potential difference in the laws.

The partnership is not taxable[71] but is a tax reporting entity for federal purposes. The federal partnership return is so constructed that it shows (a) each partner's share of taxable income or loss (ordinary income less ordinary deductions)[72] as well as (b) each partner's share of items of partnership income, gain, loss, deduction, or credit which are not lumped in taxable income.[73] The partner then copies on his individual return his individual share of the partnership's taxable income and specially allocated items of gain, loss, or deduction as a part of his federal adjusted gross income. His share of credits is not a part of his federal adjusted gross income.

2. *General Provisions of Act.*

The Act adopts the federal measure in this area by dictating that the starting point of the resident partner's Colorado income is his federal adjusted gross income.[74] That federal adjusted gross income has buried in it the individual partner's share of partnership income gain or loss.

3. *Modifications of Resident Partners.*

A partnership, just as an individual, can incur those items of income, deduction, gain, loss, or credit which the Act dictates will produce Colorado results different from the federal. In the individual area federal adjusted gross income and the federal itemized deduction were modified to give effect to these differences. In the partnership area the modifications are first computed at the partnership level on the partnership's Colorado tax reporting form[75] and then each partner's Colorado adjusted gross income or Colora-

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64 INT. REV. CODE OF 1954, § 721.
65 *Id.* § 731.
66 *Id.* §§ 741 and 742.
67 *Id.* §§ 706(c) and 708.
68 *Id.* § 707.
69 *Id.* § 736.
70 *Id.* §§ 734(b), 743(b), 754, and 755.
71 Act, § 25(1).
72 INT. REV. CODE OF 1954, § 702(a)(9).
73 *Id.* § 702(a)(1)-(8).
74 Act, § 10(1).
75 Act, § 26(1).

do itemized deduction is modified by including his share of such partnership modification with his other non-partnership modifications.[76] For example, assume that an individual has municipal interest of $100 individually and also is a member of a partnership of which his share of partnership income and loss is 50 per cent. Assume that the partnership realizes $1,000 of municipal interest. The Colorado adjusted gross income wil be determined by adding $100 and $500 to the individual's federal adjusted gross income.

The following modifications are the only adjustments which are possible on the Colorado partnership return: certain federally excluded interest;[77] certain interest on federal obligations;[78] interest on certain federal agency obligations;[79] basis adjustments;[80] amounts to prevent double taxation;[81] oil shale modifications;[82] and foreign taxes paid by a partnership but claimed as a credit by the partner for federal purposes.[83] The other modifications discussed under "Resident Individuals" are inapplicable by their nature. For example, state and federal income taxes are not levied or refunded on partnerships and therefore are not modifications. A partnership as such incurs no net operating loss deduction and therefore this type of adjustment is inappropriate in this area. The same reasoning applies to pension and retirement fund benefits.[84]

C. Corporations

1. *Measure.*

The Act ties the Colorado law to the federal by applying the former 5 per cent rate to the "net income of a corporation."[85] "Net income" is the corporation's federal taxable income with the modifications discussed below.

2. *Modifications.*

The federal taxable income is increased by four items:

(a) Certain federally excluded state interest discussed at page 346, *supra.*

(b) The federal net operating loss deduction discussed at page 347, *supra.*

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76 Act, §§ 10(5) and 26(1).
77 See page 346, *supra.*
78 See page 347, *supra.*
78 See page 347, *supra.*
80 See page 348, *supra.*
81 See page 349, *supra.*
82 See page 351, *supra.*
83 See page 355, *supra.*
84 See page 347, *supra.*
85 Act, §§ 35 and 38.

(c) Those state income taxes discussed at pages 346 and 354, *supra,* which are imposed by Colorado. The statute does not add back to the measure state income taxes imposed by states other than Colorado because such taxes which are allowed as credits to resident individuals are not credits to corporations.

(d) *Excess charitable deductions.*[86] Former Colorado law decreed that a corporation could deduct only those charitable contributions which did not exceeed 5 per cent of the corporation's net income and the excess was lost. Federal law, prior to 1964, also had a 5 per cent limitation but provided that the excess could be carried forward two years. In 1964 the carryover period was extended to five years. It was determined that future Colorado revenues should not be reduced as a result of excess corporate contributions made in 1963 and 1964. If a corporation incurs excess charitable deductions in 1965 and thereafter, the excess will be deductible in accord with the federal law.

It should be noted that no corresponding addition was made to an individual's Colorado adjusted gross income for excess charitable deductions arising in 1964. Prior to 1964, federal law prohibited the carryover of excess charitable contributions by individuals. It was believed that complicating the statute to perhaps increase revenues was not justified in the case of individuals because the excess which could conceivably affect future revenues was limited to the excess of only 1964 deductions above 30 per cent of federal adjusted gross income.

Federal taxable income is decreased by seven items:

(1) Certain interest on federal obligations discussed at page 347, *supra.*

(2) Interest on certain federal agency obligations discussed at page 347, *supra.*

(3) Basis adjustments discussed at page 348, *supra.*

(4) Amounts necessary to prevent double taxation discussed at page 349, *supra.*

(5) Those refunds of only the Colorado State income taxes discussed at page 350, *supra.* Note that refunds of income taxes imposed by states other than Colorado are not subtracted from federal taxable income because such refunds are properly income to Colorado.

(6) The Colorado net operating loss deduction discussed at page 350, *supra.*

(7) Oil shale modifications discussed at page 351, *supra.*

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[86] Act, § 38(1).

This writer believes that the statute as drafted is deficient in the following area and that corrective legislation should be enacted to effect the intent of the Act. A corporation may be a beneficiary of a trust or estate and may be a partner. Specific language should be adopted which would modify a corporation's federal taxable income by its share of the Colorado fiduciary adjustment[87] and its share of the partnership's modifications. The omission of this provision was a drafting oversight.

3. *Allocation of Multi-state Income.*

The allocation of multi-state income is particularly troublesome in the corporate area even if we ignore constitutional problems. If a resident individual has income from Colorado source and out-of-Colorado income, Colorado taxes all and he receives a credit for income taxes paid to other states. If a resident individual is a partner, he reports his full share of partnership income regardless of where that income was earned and he receives a deduction for taxes paid to other states. For non-resident individuals and non-resident partners special rules fragment Colorado source income from non-Colorado source income and the tax is paid on only the Colorado source income. The key to the allocation of multi-state income for individuals and partners is therefore the taxpayer's residence. For an individual or a partner it is relatively simple to determine whether he is a resident or a non-resident. The problem of fragmentation is further reduced from a practical standpoint because, with the possible exception of oil, gas, and hardrock mining partnerships, numerous non-resident equity owners are not involved in most businesses operated in unincorporated form. Under such circumstances the method of taxing all to a resident individual or a resident partner with a credit for taxes paid elsewhere and looking to source for non-resident individuals and non-resident partners has worked with relative practical ease.

Not so with corporations. Here the initial incidence of tax is not at the equity owner level but is instead at the composite business level. Further, more businesses with numerous equity owners involved in interstate business do so in corporate rather than partnership form. The net result is that the stakes are considerably higher in the determination of what portion of corporate multi-state income should be taxed by Colorado and what portion by other states. Additionally, the residence of a multi-state corporation is almost impossible of determination — should the criteria be the state of incorporation, the location of principal physical assets, man-

[87] See page 366, *infra*.

agement offices or payroll, the origin or destination of sales, or what? If a predominantly manufacturing state chooses to place primary emphasis on the location of the point of production should a state, if it determines that it is primarily a consuming state, be precluded from emphasizing the point of the destination of the goods? The result has been a rather topsy-turvy growth of various state allocation procedures which evidence the balancing of concepts of what is a fair allocation with the very real problem of getting as much revenue as possible from foreign non-voters. Some states permit separate accounting, some do not; some use a pure formula method of allocating income, others combine formulae with direct allocation; some formulae are based on two factors, *i.e.*, sales and property, others apply three factors, *i.e.*, sales, property, and payroll.

At the time this Act was drafted, the United States Supreme Court had upheld a tax on the net income of a foreign corporation with an in-state sales office whose orders were approved and filled out-of-state.[88] Further, the Supreme Court had refused to review a decision sustaining an income tax where the only in-state contact was the solicitation of orders.[89] Congress had passed P.L. 86-272,[90] prohibiting taxation in certain limited cases, and a congressional study group was attempting to reach some definitive conclusions to bring order from chaos.[91]

The drafting group concluded that the best way to provide for allocation of multi-state corporate income in this state of confusion was to readopt existing allocation rules and make no substantial changes. The Act therefore allocates multi-state income in basically[92] the same manner as was true under former law. The Colorado Department of Revenue has added a gloss in this area by an oral acknowledgment that it no longer considers P.L. 86-272 unconstitutional[93] and therefore it will so intepret the Act that the minimum

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[88] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

[89] International Shoe Co. v. Fontenot, 236 La. 279, 107 So. 2d 640 (1958), *cert. denied*. 359 U.S. 984 (1959)

[90] 73 Stat. 555 (1959), 15 U.S.C. §§ 381-384.

[91] The results have been published as H.R.REP. NO. 1480, 88th Cong., 2d Sess. (1964).

[92] Act, § 37. Section 37(2)(b) now declares that property shall be valued in both the numerator and denominator at the "net book value recognized for federal income tax purposes."

It may be of some historical importance to note that the Department of Revenue unsuccessfully attempted to persuade the legislature to amend the property factor by including in the numerator and denominator capitalized rentals.

[93] Evidently Colorado will abide by the decision of the Louisiana Supreme Court in International Shoe Co. v. Cocreham, 246 La. 244, 164 So. 2d

contacts set forth in P.L. 86-272 will produce no tax.

The approach of the proposed regulations in this area is of particular importance. They dictate that the first determination to be made is whether the corporation does any business out of Colorado. If it does not it will be considered a unitary business and all income will be allocated to Colorado; the allocation steps outlined below will not apply. The confusion of the following proposed regulations, admittedly taken out of context, is understandable only if the confusion in the law as pronounced by our courts and legislatures is recognized. Compare the sentence:

> Irrespective of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization in this State is doing business in this State.[94]

with the following sentence:

> Corporations *which have neither employees nor stocks of goods* in Colorado, and which engage in no activities here, other than the shipping of goods to customers in this State pursuant to orders received by mail, telephone or telegraph, are neither doing business nor deriving income from sources in this State and are, accordingly, not taxable under this Act.[95]

and also the following sentence:

> The term 'doing business' as used for purposes of process, or the fact that a corporation is qualified to do business in another state under the laws of such other state will have no standing under this Act.[96]

This author interprets the proposed regulations to mean that if a corporation has any contact with Colorado, Colorado will tax some or all income and it will assert no taxing jurisdiction only in the isolated case where the sole contact consists of shipping to Colorado customers pursuant to orders received, accepted, and filled out of Colorado by a corporation that has no Colorado employees and no Colorado inventory. It should be noted that such interpretation probably conflicts with P.L. 86-272 notwithstanding the oral acknowledgement to abide by P.L. 86-272, and also that tax avoidance is made possible in the following case: Assume a Colorado unitary business whose only contacts with another state, which state imposes no income tax, are (1) delivery in the other state and (2) at

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314, *cert. denied*, 379 U.S. 902 (1964), in which Colorado filed an amicus curiae brief.

[94] Proposed Reg. § 35.

[95] *Ibid.* (Emphasis supplied.)

[96] Proposed Reg. § 37.

least "one employee" in the other state. Under the proposed regulations since there is an out-of-state "employee" the sales delivery to the other state should logically be free of Colorado tax.

The proposed regulations dictate that the second determination to be made is the allocation of a corporation's income if it is determined that a corporation does some business out-of-Colorado:

(a) Dividends, gains, and losses from corporate stock, royalties, and similar intangible rights are directly allocated to the principal place of the corporation's business. (Principal place of business is interpreted to be the nerve center of the corporation.)[97] Rents and gains or losses from capital assets are directly allocated to the situs of the property producing such income or loss. (The proposed regulations include a questionable definition of rents by stating that if one of the principal business functions of a corporation is the rental of tangibles that such income is not "rent" and will not be directly allocated.)[98]

(b) The remainder of the income or loss is allocated according to a two-factor, property and sales, formula.[99]

The Act for the first time permits consolidated returns.[100] It is hoped that the final regulations, unlike the proposed regulations,[101] will permit the filing of consolidated returns if federal consolidated returns are filed.

The Act continues the former rule which has questionable constitutional validity that the above allocation procedures may be nullified by the Director if, "it shall appear to [his] satisfaction [that the general allocation statute] does not properly reflect the amount of income derived from sources within Colorado" and that in such case he is, "authorized in his discretion to determine a method of allocation or apportionment as is fairly calculated to determine the net income derived from, or attributable to, sources within Colorado."[102]

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97 *Ibid.*

98 *Ibid.*

99 Proposed Reg. § 37(2).

100 Act, § 39.

101 "Such permission will not be granted unless it is demonstrated to the satisfaction of the director by an overwhelming preponderance of evidence that the purposes in filing such a consolidated return are legitimate business purposes, or that such consolidated return will produce a more realistic and equitable Colorado tax liability, and that the purpose is not the evasion of tax under this Act." Proposed Reg. § 39.

102 Act, § 37(4).

D. TRUSTS AND ESTATES

1. *Background.*

Former Colorado law was based on pre-1954 federal law. The theory was that the income of a trust or estate should be taxed only once — either to the trust or the beneficiary. The fiduciary paid a tax on basically all income except for that income which was distributed or distributable to the beneficiary. Such income produced a deduction to the fiduiary and was includible by the beneficiary.

The 1954 Internal Revenue Code made wholesale revisions in this area just as it did in the partnership sections. The basic change was to give the fiduciary a deduction[103] and demand inclusion by the beneficiary[104] of all amounts paid or payable by the fiduciary, whether the source of such amounts was from income or principal (limited to the fiduciary's "distributable net income"). Distributable net income is defined[105] as taxable income modified by the deduction for distributions, the deduction for personal exemptions, certain capital gains and losses, certain extraordinary dividends and taxable stock dividends, tax exempt interest, certain income of foreign trusts, and excluded dividends.

2. *Taxation of the Resident Fiduciary.*

The Act dictates that the fiduciary copy its federal taxable income[106] as the starting point in the determination of the Colorado measure. Four modifications are made to the federal taxable income to arrive at Colorado taxable income. The rates for resident individuals previously discussed at page 342, *supra*, are then applied to the Colorado taxable income.

(a) *Colorado exemption.*[107] $750 is subtracted from the federal taxable income. This amount is equal to the former exemption allowed fiduciaries. A fiduciary must add the exemption claimed on the federal return which has reduced the federal taxable income. The addition will be $600 for an estate, $300 for a "simple trust," and $100 for a "complex trust."[108]

(b) *Basis and double taxation modifications not in distributable net income.*[109] If the trust or estate realized gain in a case

[103] INT. REV. CODE OF 1954, § 661.
[104] *Id.* § 662.
[105] *Id.* § 643(a).
[106] Act, § 45.
[107] Act, § 45(1).
[108] INT. REV. CODE OF 1954, § 642(b).
[109] Act, § 45(2). The language of the Act is especially misleading in this section. The terms of the statute refer to all modifications described in sections 10 and 13 and are not expressly limited to the basis and double taxation adjustments. Somewhere between the submission of the "Bar Bill"

where its Colorado basis was greater than the federal basis, a modification is just as necessary as it was for a resident individual discussed at page 348, *supra.* The same holds true for a modification to prevent double taxation discussed at page 349, *supra.* The Act adopts the New York philosophy that these particular modifications will be made on the fiduciary's return only if they relate to items which are excluded from distributable net income. For example, a trust sells a capital asset for $100 which has a federal basis of $70 and a Colorado basis of $95 and was held for more than six months. The trust is either silent regarding the allocation of capital gains to corpus or income or specifies that such gains will be allocated to corpus. Federal taxable income includes a gain of $15 ($30 less $15 as a long-term capital gain deduction). The fiduciary will claim a modification of $12.50 (one-half of the difference between $95 and $70).

(c) *Fiduciary's share of fiduciary adjustment.*[110] The fiduciary adjustment and its allocation between the fiduciary and the beneficiary is discussed at page 366, *infra.*

(d) *Certain non-resident beneficiary trusts.*[111] Wyoming and Nebraska have no state income tax. Assume that a trustor made a Colorado bank trustee of a trust for the benefit of a Wyoming or a Nebraska beneficiary. Assume further than someone other than the trustee has the power to remove the principal from Colorado by revocation, removal of trustee, or otherwise, and that the income is either distributed or required to be distributed to such beneficiary. With no special rule, Colorado would tax such income. Because of the fear that such trust business would be removed from Colorado, the former law provided exemption from tax in such circumstances. The Act, with this modification, continues such exemption.

3. *Taxation of the Resident Beneficiary.*[112]

We have discussed the taxation of the resident individual, the resident partner, the corporation, and the resident fiduciary. In so

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to the Colorado Department of Revenue and the printing of H.B. 1003, the words "sections 138-1-10 and 138-1-13" were inserted for the words "'section 138-1-10(3)(d) or (e)." The present statute does not implement the correct theory for two reasons, (1) the drafters intended no change from the New York approach in this area and (2) the present wording conflicts with the second sentence of section 46(2). As the statute now reads it would be possible for modifications affecting extraordinary dividends and taxable stock dividends allocable to corpus to be claimed as a modification twice.

110 Act, § 45(3).

111 Act, § 45(4).

112 Act, § 10(1).

doing, we analyzed the taxation of the resident beneficiary except for the beneficiary's share of the fiduciary adjustment. For example, the resident individual who is a beneficiary has automatically accounted for his share of the income of the estate or trust when he copies his federal adjusted gross income. The portion of such trust or estate income which he must report, except for the beneficiary's share of the fiduciary adjustment,[113] is buried in the federal adjusted gross income figure.

4. *Fiduciary Adjustment.*

In the area of partner and partnership taxation by Colorado the Act adopts the federal adjusted gross income measure at the partner level and similarly applies all modifications to that measure at the partner level. Contrariwise, in the area of corporate taxation by Colorado, we adopted the federal taxable income measure at the business level and applied all modifications to that measure at the same level.

In the area of taxation by Colorado of fiduciaries and beneficiaries, the Act creates a schizoid. It adopts federal taxable income of the fiduciary as its starting point, just as it did with corporations. The Act further adopts federal adjusted gross income of the beneficiary as its starting point, just as we did with partners. But, the modifications provided for in the Act relating to the income of an estate or trust, *i.e.*, federal interest, Colorado income taxes deducted by fiduciary, the federal income tax liability, etc., are not applied solely at the fiduciary level or solely at the beneficiary level. Instead, the fiduciary adjustment is allocated between the fiduciary and the beneficiary. What is the "fiduciary adjustment" and how do we determine what portion must be accounted for by the fiduciary and what portion by the beneficiary?

With two exceptions, the fiduciary adjustment[114] is the net total of all modifications discussed in connection with resident individuals which apply to trusts or estates whether or not such modifications relate to items which are a part of federal distributable net income. All modifications, with the two exceptions, are thrown into one pot and the potpourri is called the fiduciary adjustment. The two exceptions are the basis and double taxation modifications which are not in distributable net income.[115] These two exceptions

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[113] Act, §§ 10(4) and 46.
[114] Act, § 46(2).
[115] Act, § 46(2), second sentence. This sentence was adopted from the New York Statute which, contrary to the Colorado Statute, does not permit the deductibility of the federal tax on the state return. The Colorado Department of Revenue proposes that the entire federal tax paid by the fiduciary should be a deduction to it on its Colorado return. The present wording

are not thrown into any pot for division between the fiduciary and the beneficiary; instead, 100 per cent of these exceptions are deducted by the fiduciary as discussed at page 364, *supra*.

The fiduciary adjustment is allocated between the fiduciary and the beneficiaries in proportion to their respective shares of the fiduciary's distributable net income.[116] In a simple trust, 100 per cent of the fiduciary adjustment will be allocated to the beneficiaries. In a complex trust, if the trust has $50,000 of distributable net income and distributes $10,000 to each of two beneficiaries, the fiduciary adjustment will be allocated three-fifths to the trust and one-fifth to each of the beneficiaries. Special rules are provided in the unusual case that a fiduciary generates modifications but generates no distributable net income.[117]

E. Miscellaneous

1. *Exempt Organizations.*

The Act states that organizations will be exempt from tax to the extent that they are exempt for federal purposes.[118] The proposed regulations[119] further condition exemption on the submission to the director of evidence of federal exemption. The statute makes no demand of the necessity of evidence of federal exemption, nor was it the intent of the drafters that the Colorado exemption would be denied to an organization that does in fact satisfy federal law merely because it has not formally applied for exemption from the Internal Revenue Service or has lost its letter of exemption. The Act does tax the unrelated business income of exempt organizations.[120]

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dictates that if we have a discretionary trust with $40,000 of distributable net income which pays out only $20,000 to beneficiaries, the resulting federal tax of approximately $6,000 which is incurred entirely by the trustee is deductible $3,000 by the fiduciary $\left\{ \frac{20,000}{40,000} \text{ x } 6,000 \right\}$ and $3,000 by the beneficiaries. This author agrees that section 45(2) should be amended to read:

> There shall be subtracted the modifications described in section 138-1-19(3)(d) and (e), to the extent such items are excluded from federal distributable net income of the estate or trust, and section 138-1-13(4)(a).

A corresponding change should be made to the second sentence of section 46(2). The effect of these changes would be that the entire federal income tax liability incurred by the trustee would be deductible by the trustees and such modification would not be allocated in part to the beneficiary.

116 Act, § 46(3)(a).

117 Act, § 46(3)(b).

118 Act, § 17(1).

119 Proposed Reg. § 17.

120 Act, § 17(2).

2. *Subchapter S Corporations.*

A Subchapter S corporation is not an exempt organization although it is not subject to tax so long as the federal election remains in effect.[121] The proposed regulations[122] allocate the multi-state income of a Subchapter S corporation according to partnership rules and not corporation rules. Accordingly, all of his share of the Subchapter S multi-state undistributed taxable income will be taxed to a resident shareholder and only the Colorado source portion of such Subchapter S multi-state undistributed taxable income will be taxed to a non-resident shareholder.

The drafters had assumed, contrary to the proposed regulations, that multi-state Subchapter S income would be allocated as other intangible income. The drafters thought it best to tax all multi-state Subchapter S income to resident shareholders and tax no part of such income to non-resident shareholders. The drafters' thinking, contrary to that of the proposed regulations, would have relieved the corporation from allocating income if one shareholder were a non-resident and also would have denied the State any tax from a non-resident shareholder's share of Colorado source Subchapter S income. Only time will tell whether the final regulations continue the partnership-type allocation, and if so, whether the courts will sanction such an approach as a reasonable interpretation of the Act.[123]

3. *Procedure.*[123a]

As indicated in the beginning of this article, the drafters were concerned principally with the substantive changes to be made. Nevertheless, the Act does differ from former law in the procedural areas as follows:

(a) Filing requirements incorporated the federal concept of income.[124]

(b) For the first time, the director is given statutory authority to promulgate rates and tables which will allow employers to compute sliding scale state withholding by reference to federal withholding.[125]

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[121] Act, § 36.

[122] Proposed Reg. § 36.

[123] Act, §§ 10(1), 15(2).

[123a] Extensive revisions to the procedural rules were enacted by the 1965 General Assembly. These changes, which will be added as Chapter 138, Article 9, COLO. REV. STAT. (1963), affect procedural rules relating to income, gross ton-mile, passenger-mile, motor fuel, cigarette, sales, and use taxes.

[124] Act, § 65.

[125] Act, § 68(3)(a).

(c) The determination of the necessity of filing declarations of estimated tax are to be made consistent with federal law.[126]

(d) The "floor" for determining the necessity of filing an estimated tax return was raised from a yearly estimated tax of $20 to $40.[127]

(e) Extremely significant revisions were made in the area of extending the Colorado statute of limitations for assessment and refunds if the federal statute of limitations is extended.

The general federal statute of limitations[128] prohibits the assessment of federal deficiencies more than three years after the return is filed. The comparable portion of the former Colorado law[128a] and the Act[129] prolong the period of repose to four years. In addition, the former Colorado law provided:

> Any final determination of the federal net income made pursuant to the provisions of federal law under which such net income is found to differ from the net income originally reported to the federal government shall be reported by the taxpayer to the director of revenue within thirty days of receipt by the taxpayer of notice of such final determination, with a statement of the reasons for the difference, in such detail as the director may require. If from such report or from investigation it shall appear that the tax with respect to income imposed by this article has not been fully assessed, the director shall within one year of the receipt of such report or within one year of discovery of such determination, if unreported, assess the deficiency . . . . The statute of limitations shall not apply in the instance of any taxpayer who, within the time specified, fails to make a report of any such change made by the said commissioner of internal revenue, or other officer of the United States or competent authority.[130]

The Department of Revenue, by administrative fiat, placed the following interpretations on this exception to the statute of limitations:

(a) The final determination which had to be reported was the receipt of a revenue agent's proposed adjustment although it was never quite clear to this author whether the Department considered the 10-day, the 15-day, the 30-day, or the 90-day letter to be

126 Act, § 69(1).
127 *Ibid.*
128 INT. REV. CODE OF 1954, § 6501(a).
128a Colo. REV. STAT. § 138-1-39(1) (1963).
129 Act, § 89(1).
130 COLO. REV. STAT. § 138-1-29(5) (1963).

the revenue agent's report which had sufficient authority to be deemed a final determination.

(b) Even though the four-year Colorado statute had run before the final determination, if the taxpayer did not file his report of federal change within the 30-day period, the Colorado statute of limitations was revived and would not be deemed to finally run until one year after the receipt of the report or the discovery of the federal change.

(c) If a federal change were made 46 months after the Colorado return was filed and the taxpayer duly notified the director, the statute was tolled until one year after the receipt of the notice of change.

The drafters believed the Department's interpretations to be of questionable validity at best. The Department, in the drafting stages, agreed not to contest suggested legislative changes in this area if some mechanism could be devised to extend the Colorado statute of limitations when the federal statute was prolonged. It should be noted that the Department indicated that by its acquiescence it did not mean to imply that its interpretation of former law was incorrect. The Act presently provides:

(a) If the federal statute is extended by consent or by administrative or judicial proceedings, the normal Colorado four-year statute will not expire prior to one year after the expiration of the extended federal period,[131] and

(b) if a federal final determination is not reported to the director within 30 days, the Colorado statute is tolled only from the end of that 30-day period to the time the final determination is reported or, if earlier, until the director discovers the final determination.[132] "Final determination" is, for the first time, specifically defined.[133] The drafters felt that the Department should be notified when the dispute between the taxpayer and the federal government first reaches the stage that the taxpayer is voluntarily or involuntarily committed to conclude that he must pay the proposed federal deficiency. The Act assumes that if the federal government is going to receive additional taxes then, at that point in time, Colorado should be advised of the federal change. Accordingly, final determination is defined to be the first time that the federal government can put its billing machinery into operation, *i.e.*, when the taxpayer or the government offer or accept a waiver of assessment and col-

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[131] Act, § 65(6)(e).
[132] Act, § 65(6)(d).
[133] Act, § 65(6)(b).

lection of deficiency,[134] when the taxpayer pays any additional tax,[135] or when court judgment becomes final.[136]

The drafters trust that it is now clear that a federal final determination can only toll the Colorado statute, but cannot revive it, if not reported to the director within 30 days, and then only until the final determination is reported or discovered. It should also be noted that the Act provides a two-way street so that claims for refund are timely to the extent that an assessment for deficiency would be timely.[137]

4. *Effective Date.*

Except for the withholding provisions, the Act affects taxable years beginning after December 31, 1964.[138]

IV. CONCLUSION

This writer acknowledges that the Act is not perfect and alludes to some of the sections which must be amended. Additional changes will become apparent as we work with the new law. It is hoped that such technical changes will be relatively few because of the hundreds of donated man-hours which preceded its enactment. By the same token, this writer submits that new legislatures will do the public no real service by hastily changing substantive provisions so that additional differences will be created in the federal and Colorado measure of income. The Act as drafted with mandatory technical changes will accomplish the following objectives:

1. The vast majority of taxpayers will be able to complete their Colorado income tax returns without being forced to struggle with the legion differences which formerly existed. Almost all of the information required for the Colorado returns can now be copied directly from the federal returns.

2. It is expected that the Act will broaden the base because administrative enforcement and taxpayer compliance is greater at the federal level than at the state level. The Internal Revenue Service has what to the Colorado Department of Revenue must appear to be substantial funds with which to enforce the law. Additionally, it is generally believed that taxpayers incur greater psychological trauma if they have a tendency to "fudge" federally than is true at the local level.

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[134] Act, § 65(6)(b)(i), (ii), and (iii).
[135] Act, § 65(6)(b)(iv).
[136] Act, § 65(6)(b)(v).
[137] Act, § 65(6)(f).
[138] Colo. Sess. Laws 1964, ch. 95, § 4 at 810.

3. The Act will permit the Colorado Department of Revenue to economically utilize information obtained by the federal government from the federal electronic data processing equipment and federal audits to a much greater extent than was formerly possible. State machines will be able to process more information with the result that manpower can now be used more effectively. The federal information was always available but could not be economically utilized so long as there were minor but numerous differences between the federal and Colorado returns. The greater utilization of the federal by-product amounts to an indirect federal grant-in-aid.

4. The Act will promote uniformity and relative ease of interpretation by the automatic adoption of current federal regulations, rulings, and case law.

It requires no omniscience to realize that the state's need for money in many areas — including primary, secondary, and higher education, mental and physical medical services and programs, rehabilitating correctional programs and institutions — will increase. The state has but three broad-based taxes to accommodate these needs: property, sales, and income. Whether or not increased use is made of the property and sales taxes, it is fairly obvious that future additional emphasis will be placed on the state income tax. We hope that the Act, as interpreted by the Department of Revenue and the courts, will create an efficient mechanism to ensure that, whether directly paid to the government as tax or indirectly paid in the form of accounting and legal compliance costs, as much of the state imposition as possible reaches the deleted state programs and services which are demanded.

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NOTE

SECURITIES ACTS AMENDMENTS OF 1964

I. INTRODUCTION

On March 29, 1933, President Roosevelt delivered a message to Congress recommending "legislation for Federal supervision of traffic in investment securities in interstate commerce."[1] Two months later Congress responded with the Securities Act of 1933,[2] which regulates principally the initial distribution of securities.[3] A need for further legislation to regulate trading after the initial distribution prompted a second message to Congress recommending the regulation of the operations of exchanges in order to protect investors and eliminate speculation.[4] On June 6, 1934, Congress enacted the Securities Exchange Act of 1934.[5] The Exchange Act enabled the federal government, through the Securities and Exchange Commission, to combat the deceit, misrepresentation, and other fraudulent acts and practices which existed in the trading of listed securities for public sale.

The adoption of SEC statutes resulted in a double standard:[6] the regulation of over-the-counter markets was much less pervasive and exacting than in the case of the major exchanges.[7] This double standard persisted despite the fact that the opinion in Congress was that over-the-counter companies should comply with the same

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1 I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities . . .

There is however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public . . .

S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-2 (1933).

2 Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77a (1958).

3 1 LOSS, SECURITIES REGULATION 130 (2d ed. 1961) [hereinafter cited LOSS].

4 S. REP. NO. 792, 73d Cong., 2d Sess. 1-2 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 1-2 (1934).

5 Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78 (1958).

6 2 LOSS 1149.

7 The lag in regulation of over-the-counter markets may have been due partly to lack of information. The flow of information regarding activities in the exchange markets did not exist in over-the-counter markets. The number of broker-dealers participating in the over-the-counter markets and the number and type of issues traded in these markets was unknown. The volume of trading, size, price, and timing of individual transactions regarding over-the-counter securities were all unknown at any given time. The lack of information about over-the-counter markets was compounded by the lack of information regarding issuers of over-the-counter securities. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISION, H. DOC. NO. 95, 88th Cong., 1st Sess. Pt. 2 at 542 (1963) [hereinafter cited SPECIAL STUDY].

rules, regulations, and statutory provisions as companies whose stocks were listed on a national securities exchange.[8]

In 1963 the SEC issued to Congress the Report of Special Study of Securities Markets (hereinafter referred to as the Special Study) which served to point up the need for closer regulation of the over-the-counter markets. Over-the-counter sales of corporate securities increased from $4.9 billion in 1949 to $38.9 billion in 1961—an increase of almost 800% in twelve years. As a percentage of total exchange sales, over-the-counter sales increased from 37% to 61% between 1955 and 1961.[9] The securities traded over-the-counter are diverse in kind, price, quality, and activity;[10] and due to the virtually free access of persons into the over-the-counter securities

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[8] In 1955 the Senate Committee on Banking and Currency noted the wide disparity between protection afforded over-the-counter investors and investors in the exchange markets by the following statement. "*The committee is of the view that as a general policy, it is in the public interest that companies whose stocks are traded over-the-counter be required to comply with the same statutory provisions and the same rules and regulations as companies whose stocks are listed on national securities exchanges.*" (Italics in original.) S. Rep. No. 376, 84th Cong., 1st Sess. 9 (1953); quoted in S. Rep. No. 379, 88th Cong., 1st Sess. 16 (1963).

[9] Special Study Pt. 2 at 546-47.

[10] *Id.* at 547-48.

business there is a similar diversity of broker-dealer participants.[11] Issuers of over-the-counter securities vary considerably in asset size, shares outstanding, and number of stockholders.[12] Absence of a tape to report and publicize over-the-counter transactions increases the possibilities of a high pressure selling effort. Finally, the markup on over-the-counter securities is not disclosed to investors, and prices quoted to the public differ from the prices quoted other broker-dealers.[13]

The purpose of this Note is to sketch the evolution of the Securities Acts Amendments of 1964 through the interaction of Congress with the Securities and Exchange Commission and to indicate the effect of the new amendments on issuers whose securities are traded over-the-counter.

II. LEGISLATIVE HISTORY

As early as 1938 the board of governors of the New York Stock Exchange recognized a need for extending reporting and disclosure requirements of the Exchange Act to major companies with widely held distributed securities.[14] The Commission responded with a study "of the mechanisms whereby the investing public may most easily be afforded the protection of corporate information, proxy regulation, and the prevention of speculation by corporate 'insiders' with respect to all securities which enjoy an interstate trading market."[15]

In 1941 the New York and American Stock Exchanges recommended that Sections 14[16] and 16[17] be extended to all issuers with $3 million in assets and 300 stockholders which were engaged in interstate commerce or whose securities were dealt in by use of the mails or other interstate facilities.[18]

After a study of companies whose shares were not registered

[11] *Id.* at 548-51.
[12] A sample of 1,618 companies whose securities were traded exclusively over-the-counter at the end of 1961 showed 31% had assets in excess of $10 million, 47% had assets in excess of $5 million, and 77% had assets in excess of $1 million. Approximately half the issuers had less than 200,000 shares outstanding. Approximately half the companies had 500 or more stockholders, and 16% had 2000 or more. The total market value of stocks outstanding ranged from 20% with $10 million or over to 60% with $1 million or over. In addition, the median price of the securities in the sample was substantially below the median price of securities traded on the New York Stock Exchange at the end of 1961. SPECIAL STUDY Pt. 2 at 551.
[13] *Id.* at 552-53.
[14] 2 Loss 1152.
[15] 5 SEC ANN. REP. 57 (1939).
[16] Relating to proxy solicitation.
[17] Relating to insider reporting and trading.
[18] 2 Loss 1152.

under the Exchange Act, the Commission in 1946 proposed that the registration and reporting provisions of Sections 12 and 13 and the proxy and insider trading provisions of Sections 14 and 16 be made applicable to issuers having both $3 million in assets and 300 security holders—without limitation to stockholders. A new section would have required every issuer engaged in, or in business affecting, interstate commerce, or whose securities were traded by any means of interstate commerce, to file the registration statement and reports required by Sections 12 and 13.[19] The 1946 proposal was incorporated into a bill[20] by Representative Lea of California, but the session closed before any action could be taken by Congress.[21]

Senator Frear, chairman of the Interstate and Foreign Commerce Committee, in 1949 introduced a bill identical to the 1946 proposal,[22] but it was never reported out of committee.[23] Senator Frear met with similar success when he reintroduced the bill in 1951.[24]

On May 26, 1955, the Banking and Currency Committee recommended that companies whose securities are traded over-the-counter be treated the same as companies whose securities are listed on a national securities exchange.[25] Two days earlier Senator Fulbright, then chairman of the Banking and Currency Committee, introduced a bill similar to Senator Frear's ill-fated ones.[26] The Commission reacted without enthusiasm. It suggested some of the provisions receive further study[27] and proposed several amendments to the bill.[28]

An amended bill[29] was endorsed by the Commission in a 1956

[19] SEC, *Proposal to Safeguard Investors in Unregistered Securities*, H.R. Doc. No. 672, 79th Cong., 2d Sess. 31-32 (1946).

[20] H.R. 7151, 79th Cong., 2d Sess. (1946).

[21] S. REP. No. 379, 88th Cong., 1st Sess. 16 (1963).

[22] S. 2408, 81st Cong., 2d Sess. (1949). See Comment, *The Frear Bill: Extension of Investor Protection to Unlisted Securities*, 45 ILL. L. REV. 263 (1950); Bayne, *Around and Beyond the SEC—The Disenfranchised Stockholder*, 26 IND. L. J. 207, 222-29 (1951).

[23] 96 CONG. REC. 15, 109 (1950).

[24] S. 1860, 82d Cong., 1st Sess. (1951).

[25] See note 8 *supra*.

[26] S. 2054, 84th Cong., 1st Sess. (1955). The standards of Senator Fulbright's bill were set at $5 million of assets and 500 security holders.

[27] *Hearings on S. 2054 Before the Subcommittee of the Senate Committee on Banking and Currency*, Pt. 2, 84th Cong., 1st Sess. 1037-62 (1955).

[28] *Id.* at 1067-70. One of the Commission's suggestions was that the only criterion necessary for coverage of equity securities was 750 record holders. No asset test was believed necessary.

[29] All the standards and proposals of the Commission were met except two: a $2 million asset test and a provision for deregistration when assets fell below $1 million were retained. *Hearings on S. 2054*, *supra* note 27 at 1024.

report[30] subject to certain reservations regarding Sections 16(b) and 15(d).[31] After further hearings the Senate Banking Committee reported the bill out in July, 1957,[32] but the Senate never voted on the bill.

[30] The Commission brought up to date reports made in 1946 and 1950. Report of SEC on S. 2054 (Comm. Print 1956).

[31] The Commission noted the problem of sponsorship of security issues in the over-the-counter market by broker-dealers who also were on the issuer's board of directors. Additional time was requested to determine whether the profit recapture provisions of Section 16(b) should apply to such sponsors.

[32] For a general background of this bill see Note, *The Fulbright Bill: Extension of Investor Protection to Unlisted Securities*, 71 HARV. L. REV. 1337 (1958).

In 1961 Congress directed the SEC to study the adequacy of existing laws and regulations for protection of investors. The Special Study report, made in 1963, formed the basis for bills which ultimately became the Securities Acts Amendments of 1964.[33] The Special Study concluded a balance of theoretical and practical considerations was necessary to determine to what issuers the requirements of Sections 13, 14, and 16 should be extended.[34] Theoretically, all securities in which a public investor interest exists ought to be included.[35] Practically speaking this is impossible. Although several determinants of coverage were considered important,[36] the Special Study Group did not feel an asset test was necessary or appropriate.[37] The criterion for coverage finally adopted, however, was a double test: $1 million in assets, and a showing, after two years, of 500 or more stockholders.[38]

III. Registration Extended Under Section 12(g) of the Securities Exchange Act

The principal change in existing law made by the 1964 Amendments was the addition of Section 12(g) to the Securities Exchange Act of 1934. Section 12(g) provides for the registration of certain securities traded over-the-counter and subjects the issuers to dis-

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[33] H.R. 6789, H.R. 6793, and S. 1642, 88th Cong., 2d Sess. (1963).

[34] The standards of coverage had to be 1) reasonably reliable; 2) easily enforceable; 3) sufficiently important to the public interest to warrant the regulatory burden assumed by the government; and 4) significant in view of the burden of compliance imposed upon the issuers involved.

[35] Under the *Ralston Purina* case this is not necessarily a matter of large numbers; at least for Securities Acts purposes, an offering to a very small number of persons may be 'public' if they need the protection of disclosure, and by parity of reasoning, it may be argued that any company with outside stockholders, however few, should be included in the protective legislation. Presumably on this reasoning, at least one past legislative proposal has used standards of 10 stockholders and $500,000 of assets. Congress has fixed 100 shareholders as the standard of coverage under the Investment Company Act.

Special Study, Pt. 3 at 17. See Securities Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953); H.R. 7955, 82d Cong., 2d Sess. (1952); Investment Company Act of 1940 § 3(c)(1), 54 Stat. 797, 15 U.S.C. § 80a—3(c)(1) (1958).

[36] The characteristics most important as determinants of coverage were: 1) number of shareholders; 2) amount of assets; 3) transfers of stock; 4) concentration of holdings; and 5) trading interest in inter-dealer markets.

[37] Special Study, Pt. 3 at 34.

[38] Inclusion of the $1 million asset test removed about 17% of all companies at the 500 or more shareholder level and about 13% at the 750 or more shareholder level from coverage of the new amendments. The justification for inclusion of an asset test is twofold: 1) the administrative burden on the Commission is significantly reduced, and 2) the larger companies are better able to bear the burden of compliance than smaller ones. *Id.* at 33.

closure requirements comparable to those for securities registered on a national exchange.[39]

Several factors must exist at the end of the issuer's fiscal year before registration is compulsory.[40] Either the issuer's securities must be traded by use of the facilities of interstate commerce, or the issuer must be engaged in, or in a business affecting, interstate commerce. "Total assets" must be in excess of $1 million and a "class" of "equity security" (other than an exempted security) must exist. Finally, the class of equity security must be "held of record" by 750 persons initially and after July 1, 1966, by some 500 persons.[41]

A. *Definition of Terms*

Section 12(g)(1) uses the terms "class," "equity security," "held of record," and "total assets" in extending protection to purchasers and sellers of over-the-counter securities. It is important that the meaning of these terms—as intended by the Commission and Congress—coincide with the interpretation attached to them subsequent to enactment of the Securities Acts Amendments into law.

1. *"Class"*

Section 12(g)(5) states that "the term 'class' shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges."[42]

Section 12(g) applies only to issuers which have "a class of equity security . . . held of record by 750[43] persons."[44] Consequently it would seem that an issuer might evade being subject

[39] See Securities Exchange Act of 1934 § 12(b), 48 Stat. 892, 15 U.S.C. 78*l* (b) (1958).

[40] If the issuer, directly or indirectly, affects interstate commerce, a registration statement must be filed with the Commission:

> (A) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and
>
> (B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this section on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons . . . .

Securities Exchange Act of 1934 § 12(g)(1), added by 78 Stat. 566-67 (1964), 15 U.S.C.A. § 78*l*(g)(1) (Supp. 1964).

[41] The Special Study recommended a phased approach which would ultimately reach issuers with 300 stockholders or more. SPECIAL STUDY, Pt. 3 at 62.

[42] Securities Exchange Act of 1934 § 12(g)(5), added by 78 Stat. 568 (1964), 15 U.S.C.A. § 78*l*(g)(5) (Supp. 1964).

[43] Five hundred persons after July 1, 1966.

[44] Securities Exchange Act of 1934 § 12(g)(1), added by 78 Stat. 566-67 (1964), 15 U.S.C.A. § 78*l*(g)(1) (Supp. 1964).

to registration by varying the characteristics of different series of securities. The issuer must be sure that the differences in fact constitute separate classes. An example of the difficulties which can result is provided by a case arising under Section 16(b) of the Exchange Act.[45] In *Ellerin v. Massachussetts Mut. Life Ins. Co.*[46] the corporation had issued two series of cumulative preferred stock fourteen months apart. The defendant owned more than 10% of the smaller series issued, but not more than 10% of the two series combined. Although the series had different dividend rates, redemption prices, and sinking fund provisions, the court found that the similarities outweighed the differences; there was but a single "class" of securities.[47]

2. *"Equity Security"*

There are two main sources from which a corporation expands its assets—capital contributions by shareholders, and loans to the corporation by creditors. Capital contributions are usually evidenced by a certificate representing the amount of proprietary interest each shareholder has in the corporation. These certificates are equity securities. Section 3(a)(11) of the Exchange Act defines equity security as "any stock or similar security; or any security convertible, with or without consideration, into such a security; or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right . . . ."[48]

Voting trust certificates and certificates of deposit are equity securities only if the underlying securities are equity securities.[49]

[45] Applicability of Section 16(b) stemmed from this portion of Section 16(a): "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . . " must comply with the insider reporting provision. *Id.* § 16(a), 78 Stat. 579 (1964), 15 U.S.C.A. § 78p(a) (Supp. 1964).

[46] 270 F.2d 259, 261 (2d Cir. 1959), 34 N.Y.U.L. Rev. 625 (1959), 12 Vand. L. Rev. 928 (1959).

[47] See ABA-ALI Model Bus. Corp. Act § 15 (1961).

[48] Securities Exchange Act of 1934 § 3(a)(11), 48 Stat. 882, 15 U.S.C. § 78c(a)(11) (1958).

[49] SEC Rule 16a-2, 17 C.F.R. § 240.16a-2 (1964).

In 1953 treasury stock was determined to be an equity security.[50] Since any security which is convertible into an equity security is itelf an equity security,[51] bonds which are convertible into preferred or common stock are equity securities and warrants or rights to purchase equity securities are also equity securities. Professor Loss points out that presumably a warrant to subscribe to a convertible bond would also be considered an equity security though twice removed from the equity security itself.[52]

To preclude the necessity of registration, a corporation might issue bonds rather than equity securities to expand its assets. A company seeking more capital with a choice of issuing bonds or equity securities might choose the former source if the ratio of debt to equity is not already overbalanced.[53]

3. *"Held of Record"*

It is difficult for issuers to ascertain the number of beneficial owners of securities held by broker-dealers in street name, by banks, or by other nominees. In most cases stock transfer records provide the only means of determining the number of record holders.[54] Consequently the Commission promulgated[55] rule 12g 5-1 to provide uniform guidelines for the determination of the number of record holders:[56] each person who would be identified as the owner of the security on records which are maintained according to accepted practices is a separate holder. When securities are held of record by a corporation, partnership, trust or other organization, or by one or more fiduciaries for a single trust, estate, or account, a single record holder exists. Securities held of record by two or more persons as co-owners are treated as if one record holder exists. Outstanding unregistered or bearer certificates are each deemed to be held of record by one person unless the issuer can establish that, if registered, the certificates would be held of record by a lesser number of persons. If the issuer has reason to believe, because of the address or other indications, substantially

[50] Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir. 1953).
[51] SEC Securities Act Release No. 4725 and Securities Exchange Act Release No. 7425 (September 15, 1964) at 5 [hereinafter cited SEC Release No. 4725 and 7425].
[52] 2 Loss 1095.
[53] A substantial amount of debt necessarily involves more risk, because both the payment of interest and the amortization or repayment of principal are contractual obligations which must be met if bankruptcy is to be avoided." WESSEL, PRINCIPLES OF FINANCIAL ANALYSIS 47 (1961).
[54] CCH FED. SEC. L. REP. NO. 905, Pt. I at 77 (June 20, 1963).
[55] Under Section 3(b) of the Securities Exchange Act of 1934, the Commission has the power to "define technical, trade, and accounting terms used in this title insofar as such definitions are not inconsistent with the provision of this title."
[56] SEC Rule 12g5-1, 30 Fed. Reg. 483 (1965).

similar names on separate certificates represent the same person, only one person will be included as holding the security of record. When the issuer knows securities are held subject to a voting trust, deposit agreement, or a similar arrangement, the securities are included as held of record by the record holders of the certificates or other evidences of interest issued under such arrangement. Fractional securities issued by certain institutions in order to qualify a borrower for membership in the issuer, which will be redeemed or repurchased by the issuer when the loan is terminated, shall not be included as held of record by any person. Finally, if an issuer knows or has reason to know that the form of holding securities of record is intended to circumvent the provisions of the act, the beneficial owners of such securities shall be deemed the record holders.

4. *"Total Assets"*

The valuation methods used by some companies regarding their assets vary widely. Because certain issuers may attempt to devalue their assets arbitrarily, the administration of a statutory standard—through application of generally accepted accounting principles—assists in preventing circumvention of the statute and assures uniformity in the coverage extended. The Commission has provided such a standard in rule 12g5-2:

> For the purpose of Section 12(g) (1) of the Act, the term "total assets" shall mean the total assets as shown on the issuer's balance sheet or the balance sheet of the issuer and its subsidiaries consolidated, whichever is larger, as required to be filed on the form prescribed for registration under this section and prepared in accordance with the pertinent provisions of Regulation S-X. Where the security is a certificate of deposit, voting trust certificate, or certificate or other evidence of interest in a similar trust or agreement, the "total assets" of the issuer of the security held under the trust or agreement shall be deemed to be the "total assets" of the issuer of such certificate or evidence of interest.[57]

B. *When Registration Becomes Effective*

The registration statement must be filed within 120 days after the last day of the first fiscal year in which the issuer first meets the statutory tests.[58] The registration statement does not become

[57] SEC Rule 12g5-2, 30 Fed. Reg. 483 (1965).

[58] Securities Exchange Act of 1934 § 12(g) (1) (A), added by 78 Stat. 566-67 (1964), 15 U.S.C.A. § 78*l*(g) (1) (A) (Supp. 1964).

effective until 60 days after filing, but the Commission may direct that it become effective within a shorter period. The Commission may also direct that any issuer or class of issuers be granted a time extension regarding registration. Until the effective date of the registration statement, the civil liability sanctions of Section 18 of the Exchange Act[59] do not apply to the issuer.

C. *Information Required in Registration Statements*

The Commission may require information comparable to that required in an application to register on a national securities exchange[60] in respect of the following: 1) the organization, financial structure, and nature of the business; 2) the terms, positions, rights, and privileges of the different classes of securities outstanding; 3) holdings and remuneration of officers, directors, underwriters, and major stockholders and their material contracts with the issuer; 4) remuneration of highly compensated employees; 5) bonus and profit sharing arrangements including stock options; 6) material contracts not made in the ordinary course of business; 7) balance sheets; 8) profit and loss statements; and 9) other financial statements required by the Commission.[61]

The balance sheet and statements of profit and loss and surplus for the preceding three fiscal years must be certified by an independent public accountant. Generally, an accountant will not be deemed independent if, during the period covered by his certification, he had a direct or material indirect financial interest in the issuer, its parent, or its subsidiaries.[62]

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[59] Securities Exchange Act of 1934 § 18, 48 Stat. 897 (1934), 15 U.S.C. § 78r (1958).

[60] Securities Exchange Act of 1934 § 12(g)(1), added by 78 Stat. 566-67 (1964), 15 U.S.C.A. § 78*l*(g)(1) (Supp. 1964).

[61] Securities Exchange Act of 1934 § 12(b)(1), 48 Stat. 892 (1934), 15 U.S.C. § 78*l*(B)(1) (1958). Registration must be made on Form 10, 30 Fed. Reg. 3422 (1965).

[62] See SEC Release No. 4725 and 7425; SEC Reg. S-X, 17 C.F.R. 210 (1950).

D. *Termination of Registration*

Paragraph (4) of Section 12(g) provides for the termination of registration after the issuer files a certification with the Commission stating that the number of stockholders is less than 300 persons.[63] Registration is terminated ninety days, "or such shorter period as the Commission may determine," after filing of the certification.[64]

Issuers with securities registered pursuant to Section 12(g) of the Exchange Act continue to be subject to other provisions of the Exchange Act—Sections 13, 14, and 16—until registration terminates for each class of the issuer's registered equity securities. If, on the last day of any fiscal year, after termination of registration, any class of equity security is held of record by the required number of stockholders and the issuer has assets exceeding one million dollars, the class of equity securities will be subject to registration.[65]

E. *Exemptions From Registration*

1. *Foreign Securities*

The authority to exempt foreign securities from registration was vested in the Commission by Section 12(g)(3) whenever "such exemption is in the public interest and is consistent with the protection of investors."[66] Accordingly the Commission promulgated rule 12g3-1,[67] exempting from registration securities of foreign issuers until November 30, 1965, to give the Commission time to study the problems involved in the coverage of foreign securities.[68]

However, the Commission believes that to the extent practicable, American investors in foreign securities should be afforded the same protections to which American investors in domestic securities are now entitled.[69] Therefore it would be reasonable to

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[63] "Registrations will not alternately terminate and become reinstated because a security hovers above and below the 500 or 750 shareholder mark." CCH, SECURITIES ACTS AMENDMENTS OF 1964 WITH EXPLANATION 11 (1964).

[64] Securities Exchange Act of 1934 § 12(g)(4) added by 78 Stat. 568 (1964), 15 U.S.C.A. § 78*l*(g)(4) (Supp. 1964).

[65] SEC Release No. 4725 and 7425 at 7.

[66] Securities Exchange Act of 1934 § 12(g)(3), added by 78 Stat. 568 (1964), 15 U.S.C.A. § 78*l*(g)(3) (Supp. 1964).

[67] Securities issued by (i) any foreign government or political subdivision thereof, (ii) any national of any foreign country, (iii) any corporation organized under the laws of any foreign country, and (iv) certificates of deposit, receipts or other evidences of interest relating to any of the foregoing securities, shall be exempt from Section 12(g) of the Act until November 30, 1965.

SEC Rule 12g3-1, 17 C.F.R. § 240.12g3-1 (1964).

[68] SEC Securities Exchange Act Release No. 7427 (1964); SEC Rules 12g3-1, 17 C.F.R. § 240.12-3-1 (1946).

[69] *Ibid.*

suppose the exemption currently extended to foreign securities will not continue. On the other hand, the Commission expressly exempts *listed* foreign securities from some of the provisions which ordinarily follow in the wake of registration. Foreign issuers with securities listed on an exchange are exempt (except for North American companies) from filing current reports,[70] semi-annual reports,[71] and from the insider trading and proxy solicitation requirements of the Exchange Act.[72] Foreign issuers who are required to register under the Securities Act but whose securities are not traded on an exchange, are (except for North American companies) exempt from filing current and semi-annual reports under Section 15(d) of the Exchange Act.[73] The temporary exemption will provide the Commission with time to develop rules to determine the extent to which various foreign issuers and their insiders will be subject to the new amendments.

2. *Insurance Companies*

The traditional regulation of insurance companies by the states precludes the necessity for compliance with the requirements of the Exchange Act. The new law provides insurance companies with an exemption from the registration requirements of the act which, however, is conditioned on specified state regulation of insurance companies.[74]

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[70] SEC Rule 13a-11(b), 17 C.F.R. § 240.13a-11 (1964), 17 C.F.R. § 249.220 (1964).

[71] SEC Rule 13a-13(c)(7), 17 C.F.R. § 240.13a-13(c)(7) (1964).

[72] SEC Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (1964).

[73] SEC Rule 15d-11(b), 17 C.F.R. § 240.15d-11(b) (1964); SEC Rule 15d-13(c)(7), 17 C.F.R. § 240.15d-13(c)(7) (196)).

[74] Securities Exchange Act of 1934 § 12(g)(2)(G), added by 78 Stat. 567-68 (1964), 15 U.S.C.A. § 78*l*(g)(2)(G) (Supp. 1964), is as follows:

(2) The provisions of this subsection shall not apply in respect of —

(G) any security issued by an insurance company if all of the following conditions are met:

(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary state substantially in the manner provided by section 78p of this title.

The two year postponement of the third requirement provides state legislatures with time to draft regulatory statutes regarding insider trading.

3. *Banks*

Section 12(g) applies to securities issued by banks whose deposits are insured by the Federal Deposit Insurance Corporation. However, administration of the registration, periodic reporting, proxy solicitation, and insider trading provisions of the Exchange Act is vested not in the Commission but in three regulatory agencies. The Comptroller of the Currency will deal with securities issued by National and District of Columbia Banks, the Board of Governers of the Federal Reserve System with state banks which are members of the Federal Reserve System, and the Federal Deposit Insurance Corporation will deal with all other insured banks.[75] Banks not subject to administration by one of the foregoing federal bank regulatory agencies will be required to comply with the provisions of Sections 12, 13, 14 and 16 as administered by the Commission.

4. *Other Exemptions*

Registration is not required under Section 12(g) when the following types of over-the-counter securities are involved:[76] 1)

[75] Securities Exchange Act of 1934 § 12(i), added by 78 Stat. 569 (1964), 15 U.S.C.A. § 78*l*(i) (Supp. 1964).

[76] Securities Exchange Act of 1934 § 12(g)(2), added by 78 Stat. 569 (1964), 15 U.S.C.A. § 78*l*(g)(2) (Supp. 1964).

any security which is listed and registered on a national securities exchange; 2) securities issued by investment companies registered under Section 8 of the Investment Company Act of 1940;[77] 3) securities (other than stock generally representing non-withdrawable capital) of savings and loan associations and similar institutions; 4) securities issued by charitable organizations which pay none of their net earnings to private shareholders or individuals; 5) securities issued by a "cooperative association" as defined in the Agricultural Marketing Act of 1929[78] or by a federation of such cooperative associations; 6) securities of certain non-profit mutual or cooperative organizations which supply a commodity or service primarily to members; and 7) obligations of, or obligations guaranteed by, the United States, a state, or a political subdivision of a state.[79] A separate registration of listed securities is obviously unnecessary since they are already subject to the same requirements as those of the new law. By the same token, investment companies subject to the Investment Company Act must meet comparable requirements.[80]

The exemption for charitable issuers, as recommended by the Special Study, and of savings and loan associations and similar groups, was included as there is normally no trading interest in their securities.[81] The exemption of federal, state, and municipal obligations carries over from the previous act, as recommended by the Special Study.[82]

In accordance with a Commission recommendation made after hearing testimony on the new bill, Congress added a statutory exemption for securities of cooperative associations.[83] Two types are exempted:[84] cooperatives, as defined in the Agriculture Marketing Act of 1929,[85] and certain other cooperatives, particularly rural electrification cooperatives. The exemption arose because these securities represent a limited interest—merely a voting right. They are nontransferable[86] and the holder receives no dividend.[87]

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[77] 54 Stat. 789 (1940), 15 U.S.C. § 80a-8 (1958).
[78] 46 Stat. 11 (1949), 12 U.S.C. § 1141 (1958).
[79] Securities Exchange Act of 1934 § 3(a)(12), 48 Stat. 882, 15 U.S.C. § 78c(a)(12) (1958).
[80] 54 Stat. 789 (1940), 15 U.S.C. § 80a-8 (1958).
[81] S. REP. NO. 379, 88th Cong., 1st Sess. 61 (1963).
[82] SPECIAL STUDY, Pt. 3 at 63.
[83] H.R. REP. NO. 1418, 88th Cong., 2d Sess. 11 (1964).
[84] Securities Exchange Act of 1934 § 12(g) (2) (E) & (F), adde dby 78 Stat. 569 (1964), 15 U.S.C.A. § 78*l*(g) (2) (E) & (F) (Supp. 1964).
[85] 46 Stat. 11 (1929), 12 U.S.C. § 1141 (1958).
[86] *I.e.*, nontransferable except to successors in interest or occupancy of the premises serviced by the cooperative. Securities Exchange Act of 1934 § 12(g) (2) (F), added by 78 Stat. 569 (1964), 15 U.S.C.A. § 78*l*(g) (2) (F) (Supp. 1964).
[87] H.R. REP. NO. 1418, 88th Cong., 2d Sess. 11 (1964).

The Commission has power to exempt issuers of securities from all or part of the provisions relating to registration of over-the-counter securities, periodic reporting, and proxy solicitation. Officers, directors, or stockholders of the issuer may also be exempted from the insider trading provisions of Section 16 of the Exchange Act. The Commission has the authority to classify issuers and prescribe different exemptions and requirements for different classes.[88] The number of stockholders, asset size, nature and extent of the business activities, income, and trading interest in the securities constitute appropriate bases for classification.[89]

IV. IMPACT OF SECTION 12(g) UPON REPORTING, PROXY SOLICITATION AND INSIDER TRADING PROVISIONS.

Once a stock is registered, the issuer is subjected to other forms of supervision by the Commission. Periodic reports are necessary, the rules for proxy solicitation must be followed, and the corporation's officers, directors, and 10% stockholders are subject to the provisions of insider trading. Registration ultimately demands far more than appears on the surface.

A. *Periodic Reports*

Prior to the new amendments only issuers of securities registered on a national securities exchange were required to file the periodic and other reports required by Section 13 of the Exchange Act.[90] Amended Section 13 now requires reports of "every issuer of a security registered pursuant to section 12 of this title."[91] Furthermore, many issuers who are not required to register under Section 12, either because the asset and stockholder requirements are not met[92] or because the type of security does not necessitate registration,[93] are nevertheless subjected to the reporting requirements of Section 13 by the provisions of amended Section 15(d).[94]

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88 Securities Exchange Act of 1934 § 12(h), added by 78 Stat. 568 (1964), 15 U.S.C.A. § 78*l*(h) (Supp. 1964).

89 *Ibid.*

90 "Every issuer of a security registered on a national securities exchange shall file the information, documents, and reports below specified . . . ." Securities Exchange Act of 1934 § 13(a), 48 Stat. 894, 15 U.S.C. § 78m(a) (1958).

The documents which must be filed include current reports with respect to major events such as changes in the amount of securities outstanding and revaluation of assets (Form 8-K), semi-annual reports on operations (Form 9-K) and comprehensive annual reports and financial statements (Form 10-K).

91 *Id.* § 13(a), added by 78 Stat. 569 (1964), 15 U.S.C.A. § 78m(a) (Supp. 1964).

92 See note 40 *supra*.

93 Section 12(g) applies only to equity securities.

94 See S. REP. NO. 379, 88th Cong., 1st Sess. 67-69 (1963).

Under the latter section, each issuer who files a registration statement which becomes effective pursuant to the Securities Act of 1933 is required to file the reports required by Section 13 of the Exchange Act.[95]

B. *Proxy Solicitation*

The 1964 amendments have broadened the authority of the Commission over proxy solicitations. Formerly it was unlawful for any person to use the mails or instrumentalities of interstate commerce to solicit proxies in respect of securities registered on any national securities exchange "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."[96] The new law extends the SEC's rulemaking authority to proxies solicited in respect of any security registered pursuant to Section 12.[97]

[95] Under Section 15 an issuer is required to file periodic reports regardless of the kind of security for which a registration statement is filed. If however, on the first day of any fiscal year, other than the fiscal year in which the registration becomes effective, the securities in the class to which the registration relates are held by less than 300 persons, the filing of reports is not necessary. Securities Exchange Act of 1934 § 15(d), 78 Stat. 574 (1964), 15 U.S.C.A. § 78*o*(d) (Supp. 1964).

[96] Securities Exchange Act of 1934 § 14(a), 48 Stat. 895, 15 U.S.C. § 78n(a) (1958).

[97] *Id.*, as amended 78 Stat. 569 (1964), 15 U.S.C.A. § 78n(a) (Supp. 1964).

Section 14(b) has not only been extended to include securities registered under Section 15,[98] but has also been amended to close a significant gap in its coverage.[99] According to a 1959 survey by the New York Stock Exchange, 8% of all securities owned by public investors were held in "street name" by brokers or dealers.[100] Under the theory that beneficial owners of these securities should determine whether and to whom proxies should be given, Section 14(b) provided that proxies could be given by the broker-dealer only in accordance with rules prescribed by the SEC. Unfortunately it failed to give the Commission power to require broker-dealers to transmit solicitation material to the beneficial owners of securities held in street name, and to give proxies in accordance with the directions of such owners. Since the broker-dealers could therefore avoid any SEC rules merely by failing to give proxies, no rules were ever promulgated.

The amended Section 14(b) gives the Commission the needed authority to adopt rules under which registered broker-dealers could not refrain from giving proxies with respect to securities held by them for the account of customers. This amendment will of course have no effect until the Commission has adopted implementing rules and regulations.[101]

SEC rules promulgated pursuant to Section 14(a) require the disclosure of considerable information regarding the issues in all proxy statements covered by that section,[102] but such disclosure can be avoided by the simple expedient of not soliciting proxies.[103] Although the New York and American Stock Exchanges require all listed companies to agree to solicit proxies for all meetings of shareholders,[104] the same requirements have not applied to unlisted companies or companies listed on other exchanges.[105] Section 14(c), added to the Exchange Act by the 1964 amendments, requires an issuer who does not solicit proxies to send to holders of securities—registered and listed on a national exchange or registered pursuant to Section 12(g) of the Exchange Act—substantially the same information required of issuers soliciting proxies.[106]

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98 S. REP. NO. 379 at 23-24, 88th Cong., 1st Sess. (1963).

99 *Ibid.*

100 CCH, SECURITIES ACTS AMENDMENTS OF 1964 WITH EXPLANATION 16 (1964).

101 SEC Release No. 4725 and 7425 at 9.

102 17 C.F.R. § 240.14a-1 to § 240.14a-11 (1964).

103 S. REP. NO. 379 at 24, 88th Cong., 1st Sess. (1963).

104 See LISTING AGREEMENT, Part III, Item 5 and LISTING FORM L, Item 5, American Stock Exchange Guide 8955; NYSE LISTING AGREEMENT, New York Stock Exchange Company Manual A-28.

105 *Supra* note 92.

106 Securities Exchange Act of 1934 § 14(c), added by 78 Stat. 570 (1964), 15 U.S.C.A. § 78n(c) (Supp. 1964).

Issuers will not be subject to this requirement until the Commission has implemented the provision by rules and regulations.[107] Such a regulation has been proposed and is presently being considered by the Commission.[108]

C. *Insider Trading*

Section 16[109] embodies three separate, closely integrated provisions to discourage the abuse of inside information. Section 16(a) requires officers, directors, and over-10%-stockholders ("insiders") to disclose the amount of, and any change in, their holdings in the equity securities of the issuer. Section 16(b) provides for recovery by the issuer of any "short-swing" profits[110] made by insiders trading in the issuer's equity securities. Section 16(c) makes it unlawful for insiders to engage in short sales or "sales against the box."[111]

The 1964 amendments extended the protection of Section 16 to investors in any security registered under Section 12. They also added a specific exemption from the short-swing profit and short sale (but not the disclosure) provisions of Section 16 in favor of a broker-dealer who is making a market for the security in the ordinary course of his business.[112]

This exemption was adopted in spite of a contrary recommendation by the Special Study. The Special Study recognized that a problem exists when a broker-dealer is a corporate director while making a market for the corporation's securities.

> Where a broker-dealer has inside information through a directorship, there may be a violation of obligation to the corporation and its stockholders if the information is used, and, at least in some circumstances, there may be a violation to customers if it is not used, especially if the customers have been led to rely on the protection flowing from his close affiliation with the corporation.[113]

Those in favor of maintaining the broker-dealer's dual role proposed an exemption for two reasons. First, the presence of a

[107] SEC Release No. 4725 and 7425 at 9.
[108] Proposed SEC Reg. 14C, 30 Fed. Reg. 711 (1965).
[109] Securities Exchange Act of 1934 § 16, 48 Stat. 896 (1934), 15 U.S.C. § 78p (1958), as amended 78 Stat. 579 (1964), 16 U.S.C.A. § 78p (Supp. 1964).
[110] Any profit realized from any purchase and sale, or any sale and purchase, of any equity security of the issuer within any period of less than six months is a "short swing" profit.
[111] A "sale against the box" is a device whereby the record owner of shares sells his holdings but fails to deliver the stock certificates to the buyer within a reasonable time. The seller's change of position thus does not become known until a later date.
[112] Securities Exchange Act of 1934 § 16(d), 78 Stat. 579 (1964), 15 U.S.C.A. 78p(d) (Supp. 1964).
[113] SPECIAL STUDY, Pt. 5 at 64.

broker-dealer on the board helps protect customers who purchase the issue. Second, because of his experience, he is able to provide guidance to inexperienced companies regarding matters of financial and shareholder relations.[114] Opponents to the exemption stated that a director is a fiduciary and consequently cannot use inside information for his own benefit. Furthermore, because the central purpose of Section 16 is to enforce fiduciary obligations of directors, officers, and 10% owners, the provision of an exemption vitiates the protection afforded by Section 16.[115]

The Special Study felt the problem had been greatly exaggerated:

> Only a small segment of all over-the-counter issuers are involved; many broker-dealers, if faced with the choice of resigning as director or abandoning a trading market, would doubtless choose to resign rather than cease trading; and except in a very rare case it is difficult to conceive of

[114] *Id.* Pt. 3 at 43.
[115] *Id.* Pt. 5 at 63-66.

any individual's indispensability as both director and market maker.[116]

The Special Study recommended no exemption, but instead advised that the Commission be empowered to provide limited exemptions on an affirmative showing of unique need of the issuer and necessity or appropriateness for the public interest.[117] It was felt that disclosure provisions of the new law would eliminate the lack of information which existed and thereby remove the main reason underwriters felt the need to remain on the boards of companies whose securities were not listed.

Despite the recommendation of the Special Study, Congress adopted the exemption as proposed by the SEC. The exemption is available only for purchases and sales made by the dealer in the ordinary course of business and incident to establishment of a primary or secondary market for the securities other than on an exchange. The exemption is not available for transactions in securities which are, or at any time have been, held by the dealer in a segregated investment account. The Commission may define and prescribe the terms and conditions such as "held in an investment account" or "in the ordinary course of business" as it deems necessary in the public interest.[118] The exemption is limited to transactions by dealers in securities for which they are making an over-the-counter market; therefore, the dealer must indicate his willingness to other brokers and dealers to buy and sell such securities on a regular basis for his own account at the time of the transaction.[119] A dealer is generally regarded as making the primary or principal market if other dealers and brokers, having orders to buy or sell the security, look to him as the principal source for execution of such orders. A transaction by a dealer however, is not exempt if incident to a market established or maintained by another dealer. But, if more than one dealer is making the market at the same time, the market-making transactions of all the dealers would be exempt. To determine whether a dealer is a beneficial owner of more than 10% of a class of registered security, the securities in both his trading and investment account would be counted.[120]

It should be noted that Section 12(h) empowers the Commission to exempt in whole or in part any issuer or class of issuers from the registration, reporting, and proxy provisions of Sections

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[116] *Id.* Pt. 3 at 62.
[117] *Id.* at 63-64.
[118] SEC Release No. 4725 and 7425.
[119] S. REP. NO. 379, 88th Cong., 1st Sess. 70 (1963).
[120] *Ibid.*

12(g), 13, 14, and 15(d), and to exempt any person from the insider trading provisions of Section 16. Thus, certain transactions of broker-dealers which are deemed necessary, appropriate, and in the public interest will be completely exempt from Sections 16(b) and (c).

V. Conclusion

The enactment of S. 1642 into law makes available to the Commission all the tools it considers necessary for adequate investor protection. In the course of the hearings on H.R. 6793 the chairman of the Commission, William L. Cary, assured a House committee that the enactment of S. 1642 into law would provide the needed protection to investors. Mr. Staggers, chairman of the committee, asked Chairman Cary the following question:

> If this bill is considered favorably by the committee and enacted by the Congress, with any amendments that we might put into it, will you then have the tools which you think are adequate for the protection of the American investment public?
>
> I want no slip-up on this. You have indicated in your previous appearance time and time again that the Commission is not lacking power in the rulemaking field to do most of the things that are necessary to protect the American investor. So I ask you again, with this bill, will you have the tools that you need to give adequate protection to the American investment public?

Chairman Cary replied:

> Mr. Chairman, I would say we do. In other words, we don't promise to do a perfect job, but we will do the best job we know how and think we would have the powers.[121]

The new amendments will have far-reaching effects in the investment industry. While investors may feel more secure in the choice of their investments, the enactment of the amendments into law does not preclude the necessity of investigation on the investor's part. It should be understood that the securities laws were designed to facilitate informed investor analyses and careful discriminating investment decisions by the investing public. The investor—not the Commission—must make a judgment as to the value of the worth of securities offered for sale. The new law merely demands disclosure of information on which to base such a judgment. The rest is up to the investor.

Elliott R. Husney

H.S. Rep. No. 1418, 88th Cong., 2d Sess. 6-7 (1964).

COMMENTS

FUTURE INTERESTS—DEVOLUTION OF A POSSIBILITY OF REVERTER IN COLORADO. *School Dist. No. Six v. Russell,* 396 P.2d 929 (Colo. 1964).

". . . unto the said party of the second part [a school district] its heirs and assigns forever . . .[1]

"It is understood and agreed that if the . . . land is abandoned by the said second parties and not used for School purposes then the . . . land reverts to the party of the first part."[2]

This inept language was aptly construed by the Supreme Court of Colorado in an opinion which is noteworthy both for what is expressed and for what is necessarily to be inferred from the decision.

If the deed had said, "unto the said party of the second part its heirs and assigns, so long as the land is used for school purposes, and no longer, whereupon it shall revert to the party of the first part and his heirs," the grantee would have had a fee simple with a special limitation and the grantor would have had a possibility of reverter.[3]

If the deed had said, "unto the said party of the second part its heirs and assigns, but if the land is abandoned by the said second party and not used for school purposes then the party of the first part and his heirs shall have the power to terminate the estate hereby granted," the grantee would have had an estate in fee simple subject to a condition subsequent, and the grantor would have had a power of termination.[4]

The actual deed was a hybrid. "If" is the language of condition; "reverts" is the language of limitation. The court recognized this difficulty, and avoided subjecting itself to the compulsion of words that were so obviously inappropriate. Instead, it relied upon the purpose of the grantor, and a sophisticated rule of construction quoted from the American Law of Property:

> If the purpose is to compel compliance with a condition by the penalty of forfeiture, an estate on condition arises, but if the intent is to give the land for a stated use, the estate to cease when that use or purpose is ended, no penalty for a breach of condition is involved, since the purpose is not to enforce performance of a condition, but to convey

[1] This portion of the deed was not quoted in the court's opinion but may be found in the Brief of Plaintiff in Error, Appendix A, p. 1.
[2] School Dist. No. Six v. Russell, 396 P.2d 929, 930 (Colo. 1964).
[3] RESTATEMENT, PROPERTY § 44 (1936).
[4] *Id.* § 45.

> the property for so long as it is needed for the purpose for which it is given and no longer. Therefore, in spite of language of condition, if the prevailing purpose is to create a collateral limitation of this kind, and not to enforce a condition by a threatened forfeiture, a fee on limitation results."[5]

Under this rule the court determined that the deed had created "an estate in fee simple determinable,"[6] that is a fee simple with a special limitation, and that the grantor had therefore retained a possibility of reverter, not a power of termination. The court did not mention instances in which a contrary result would be reached under this rule, but it would seem that the "liquor clause" cases would be good examples.

Having thus classified the reversionary interest as a possibility of reverter, the court took occasion to refer to its 1939 decision in *Union Colony Co. v. Gallie*[7] and to correct its "language which has created confusion and uncertainty in the law with regard to the problem here presented."[8] This return to orthodoxy was not to have been expected, because in 1963[9] the court quoted with apparent approval some of the confusing language in *Union Colony Co. v. Gallie.*

What difference did it make in this case whether the reversionary interest was a possibility of reverter or a power of termination? The answer to this question is very important, but it must be inferred. In 1942 the court had held[10] that a one-year statute of limi-

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[5] 396 P.2d at 931-32. The part of the opinion which includes this quotation did not appear in the court's original opinion dated November 30, 1964. The modified opinion of December 21, 1964, however, included the quoted paragraph.
[6] *Ibid.*
[7] 104 Colo. 46, 88 P.2d 120 (1939).
[8] 396 P.2d at 932.
[9] Cole v. Colorado Springs Co., 381 P.2d 13 (Colo. 1963).
[10] Wolf v. Hallenbeck, 109 Colo. 70, 123 P.2d 412 (1942).

tations[11] barred the assertion of a power of termination. Here, in spite of the School District's contention that the statute was a bar, and the admitted fact that more than a year had elapsed between the cessation of use and the bringing of the action, the court sustained the possibility of reverter. The necessary inference is that, as such, it was not affected by the statute. This had never before been decided. It is not here expressed, but there is no other way to account for the decision, and it explains the decisive importance of the court's classification of the interest. If it had been a power of termination it would have been barred by the statute; since it was a possibility of reverter it was not barred. The result can of course be justified by the fact that a possibility of reverter is automatic and requires no act upon the part of the one who has it; a power of termination must be asserted. The statute says, "No action shall be commenced or maintained to recover . . . or to enforce . . . or to compel. . . ."[12]

This leaves for consideration what is perhaps the most interesting part of the decision, namely, the devolution of the possibility of reverter from the time of the grantor's death in 1930.

It was contended that a possibility of reverter was not "subject to grant, devise or inheritance,"[13] and that only those who would have been the heirs of the grantor at the time of the happening of the limiting event could represent him at that time and thereby acquire the estate. The common law authority for this proposition necessarily relates only to powers of termination upon breach of conditions subsequent, because there is such a paucity of English common law relating to possibilities of reverter that it has been doubted that such an interest could have been created after the statute of Quia Emptores, 1290.[14]

The court expressly rejected this argument and adopted the rule that "the possibility of reverter is cast by descent upon the person's heirs, at the time of his death."[15] An attempt to apply any rule other than that of the statute of descent and distribution[16] might

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[11] COLO. STAT. ANNO. 1935, Ch. 40, § 154 (now COLO. REV. STAT. § 118-8-4 (1963)).

[12] COLO. REV. STAT. § 118-8-4 (1963).

[13] 396 P.2d at 930.

[14] See, *e.g.*, GRAY, THE RULE AGAINST PERPETUITIES § 32 (4th ed. 1942): "In accordance with the doctrine of the foregoing section, no possibility of reverter after a determinable fee has been sustained in England since the Statute *Quia Emptores*."

[15] 396 P.2d at 932.

[16] The applicable statute, COLO. STAT. ANNO. 1935, Ch. 176, § 1, said, "Any real estate or property having the nature or legal character of real estate . . . shall descend . . . . " COLO. REV. STAT. § 153-2-1 (1963) is the same.

lead a court into consideration of such unfamiliar rules of descent as those pertaining to primogeniture and ancestral lands.

The decision to apply the ordinary rules of descent to possibilities of reverter was all that was said about the devolution of the interest, and the problems of devise and inter vivos conveyance were apparently left unanswered. However, the court did find that one Mary Sander was the owner of the estate which had reverted. In one place it is said that she is "the grantee in a deed from persons who were the heirs and devisees of the said Agnes F. Russell"[17] who was the sole heir of the grantor. In another place it is said "Mary Sander secured a deed from persons who, through inheritance and devise succeeded to the rights originally held by Russell [the grantor] under the possibility of reverter created by him."[18]

It is impossible for the same interest to be acquired both by inheritance and by devise, and whenever a testator appears to devise property to a person who is his heir, it is necessary to consider the applicability of the doctrine of worthier title in order to determine whether the person who took the property took as heir or as devisee. The facts which are needed are, fortunately, included in Appendix B of the Brief of Plaintiff in Error. It contains an abstruct of the chain of title from Herbert A. Russell, the original grantor, to Sander, in whom title is now quieted. The entries are as follows:

March 11, 1890	Deed, Russell to School District.
June 4, 1930	Herbert A. Russell dies intestate, with widow, Agnes F. Russell, as sole heir.
May 20, 1950	Agnes F. Russell dies testate, leaving a brother, David M. Bell, and sister, Jane B. Darling, with residue to Jane B. Darling.
May 12, 1955	Jane B. Darling dies testate leaving her residuary estate to her heirs, Mort W. Darling (husband), and children, Dewey L. Darling, Ray W. Darling, and Satia May Turner.
Aug. 10, 1955	Mort W. Darling dies testate with residuary estate to his heirs, Dewey L. Darling, Ray W. Darling, and Satia May Turner.
June 1960	School discontinued at school site but possession retained by School District.

[17] 396 P.2d at 930.
[18] 396 P.2d at 932.

May 1, 1962	School District files complaint for quiet title.
Nov. 5, 1962	Sander records October 26, 1962 Quit Claim Deed from David M. Bell, Dewey L. Darling, Ray W. Darling, and Satia May Turner.

It is apparent that when the grantor, Herbert F. Russell, died intestate on June 4, 1930, his possibility of reverter descended to his only heir, his widow, Agnes F. Russell. When she died, on May 20, 1950, it is to be inferred that her only heirs were a brother and a sister. It is further to be inferred, since the subsequent links in the chain of title do not include the brother, that the possibility of reverter was included in the residuary devise to the sister, Jane B. Darling. Did she take it as a devisee or as an heir?

This depends upon whether the doctrine of worthier title is applicable. In a case in which the doctrine was applied, the Supreme Court of Oregon quoted Blackstone's statement of the rule:

"But if a man . . . devises his whole estate to his heir at law, so that the heir takes neither a greater nor a less estate by the devise than he would have done without it, he shall be adjudged to take descent. . . ."[19]

The rule is applicable even though the heir is named, as in the present case, "to my sister, Jane B. Darling." It has been stated that the "test . . . is to strike out of the will the particular devise to the heir, and then, if without that he would take by descent exactly the same estate which the devise purports to give him, he is in by descent. . . ."[20]

It might appear that in the present case the doctrine would not be applicable because as heir, the sister would have taken only an individed one-half interest in the possibility of reverter (the other half going to her brother), whereas by the residuary clause she was devised the entire interest. However, under the orthodox rule this sort of difference would not prevent the application of the doctrine.[21]

There is, though, another factor in this case which does prevent the doctrine from being applicable. As an heir, she would have inherited with her brother as a tenant in coparcenary,[22] but under the will she took as tenant in severalty. This difference in tenure

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[19] Cordon v. Gregg, 164 Ore. 306, 101 P.2d 414, 415 (1940).
[20] Harper & Heckel, *The Doctrine of Worthier Title*, 24 ILL. L. REV. 627, 635 (1930).
[21] *Id.* at 642.
[22] COLO. STAT. ANNO. 1935, Ch. 176, § 1, the applicable statute on May 20, 1950, provided, "it shall descend . . . in parcenary . . . . " COLO. REV. STAT. § 153-2-1 (1963) is the same.

is enough to take the devise out of the doctrine of worthier title.[23] Therefore, Jane B. Darling took not as heir, but as devisee. Since the title which was quieted in Mary Sander was derived from Jane B. Darling, the decision of this case included, by necessary inference, the first decision that a possibility of reverter was devisable in Colorado.[24]

Nothing pertaining to the devolution of a possibility of reverter would be gained by a further study of the chain of title. The first transfer, on June 4, 1930, required a holding that a possibility of reverter was inheritable in the ordinary manner in Colorado, and this was expressly stated by the court. The next transfer on May 20, 1950, necessarily involved a decision that a possibility of reverter was devisable in Colorado. The decision left unanswered the question as to whether a possibility of reverter could be conveyed by deed in Colorado, because there was no such transfer in this chain of title until November 5, 1962, after the estate had reverted.

*Thompson G. Marsh**

CONSCIENTIOUS OBJECTORS—DEFINITION OF RELIGIOUS BELIEF —A BELIEF WHICH OCCUPIES A PLACE IN THE LIFE OF ITS POSSESSOR PARALLEL TO THAT ORDINARILY FILLED BY AN ORTHODOX BELIEF IN GOD IS A RELIGIOUS BELIEF. *United States v. Seeger,* 85 Sup. Ct. 850 (1965).

Daniel Seeger claimed exemption from military service as a conscientious objector,[1] but left open the question as to his belief in a Supreme Being. He declared, however, that his agnostic philosophy did "not necessarily mean lack of faith in a purely ethical creed."[2] Although the government conceded that Seeger's abhor-

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23 Harper & Heckel, *supra* note 20 at 639-640.

24 The applicable statute, COLO. STAT. ANNO. 1935, Ch. 176, § 36, said, " . . . shall have the power to . . . devise . . . any or all the estate, right, title and interest in possession, reversion or remainder . . . of, in and to any lands, tenements, heriditaments, annuities or rents charged upon or issuing out of them . . . . " COLO. REV. STAT. § 153-5-1 (1963) says, " . . . may devise . . . real . . . property or any interest therein . . . . "

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1 50 U.S.C. App. § 456(j) (1951): Seeger's claim was made under § 6(j) of the Universal Military Training and Service Act:

> Nothing contained in this title [§ § 451-454 and 455-471 of this Appendix] shall be construed to require any person to be subject to combatant training and service in the armed forces of the United States who, by reason of religious training and belief, is conscientiously opposed to participation in war in any form. Religious training and belief in this connection means an individual's belief in a relation to a Supreme Being involving duties superior to those arising from any human relation, but does not include essentially political, sociological, or philosophical views or a merely personal moral code.

2 85 Sup. Ct. at 854.

rence of war was both sincere and predicated on "religious training and belief,"[3] the selective service board denied his claim solely on the grounds that it was not based upon a "belief in a relation to a Supreme Being" as required by § 6(j) of the Universal Military Training and Service Act.[4] Seeger was convicted in the District Court for the Southern District of New York of having refused to submit to induction in the armed forces.[5] The Court of Appeals for the Second Circuit reversed the conviction, holding that the Supreme Being requirement of the act violated the due process clause of the fifth amendment by creating an impermissible classification between internally derived and externally compelled "religious" beliefs.[6] The Supreme Court affirmed without reaching the constitutional issue, holding that "the test of belief 'in a relation to a Supreme Being' is whether a given belief that is sincere and meaningful occupies a place in the life of its possessor parallel to that filled by the orthodox belief in God of one who clearly qualifies for the exemption."[7]

Religious objectors have been provided with some form of military exemption since 1775 when the First Continental Congress passed a resolution to exempt those who, because of their "religious principles," could not bear arms.[8] The Federal Conscription Law of 1863[9] contained no such exemption but one was included in the 1864 Draft Law.[10] The Draft Act of 1917[11] restricted exemption to members of "any well-recognized religious sect . . . whose existing creed or principles [forbade] . . . its members to participate in war in any form."[12] In 1940 Congress broadened the exemption significantly by including not only members of the historic peace churches but also individuals "who, by reason of religious training and belief" are opposed to war in any form.[13] The 1940 act was modified in 1948[14] to include within the definition of "religious training and belief" the requirement of "belief in a relation to a Supreme Being" with which the *Seeger* case deals.

Although the Court of Appeals decided *Seeger* on constitution-

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3 United States v. Seeger, 326 F.2d 846, 847 (2d Cir. 1964).
4 85 Sup. Ct. at 854.
5 United States v. Seeger, 216 F. Supp. 516 (S.D.N.Y. 1960).
6 United States v. Seeger, 326 F.2d 846 (2d Cir. 1964).
7 United States v. Seeger, 85 Sup. Ct. 850, 854 (1965).
8 2 JOURNALS OF THE CONTINENTAL CONGRESS 189 (1905).
9 Act of March 3, 1863, ch. 75, § 2, 12 Stat. 731.
10 Act of Feb. 24, 1864, ch. 13, § 17, 13 Stat. 9. The exemption extended to conscientious objectors who were members of religious denominations prohibited from bearing arms by the articles of faith of their denominations.
11 Act of May 18, 1917, ch. 15, § 4, 40 Stat. 76.
12 *Id* 40 Stat. at 78.
13 Selective Training and Service Act of 1940, ch. 720, § 5(g), 54 Stat. 889.
14 50 U.S.C. App. § 456(j) (1951).

al grounds,[15] the Supreme Court eschewed any constitutional determination.[16] Instead it chose to define the term "Supreme Being" as something other than the orthodox concept of God. This definition served to resolve a conflict between the Second and Ninth Circuits which existed between 1940 and 1948, and continued even after Congress attempted to settle it in the 1948 amendment.

The conflict had its origin in 1943 in the broad definition of "religious training and belief" supplied by Judge Augustus Hand in *United States v. Kauten.*[17] Hand said that "the provisions of the present statute [the 1940 act] . . . take into account the characteristics of a skeptical generation and make the existence of a conscientious scruple against war in any form, . . . the basis of exemp-

[15] 326 F.2d 846 (1965). The Court of Appeals had decided *Seeger* on the due process clause of the fifth amendment.

[16] The Supreme Court has thus far refused to consider the constitutionality of the "religious training and belief" and "Supreme Being" provisions. Etcheverry v. United States, 320 F.2d 873 (9th Cir.), *cert. denied,* 375 U.S. 930 (1963); Clark v. United States, 236 F.2d 13 (9th Cir.), *cert. denied,* 344 U.S. 843 (1952). However the Selective Draft Law Cases, 245 U.S. 366 (1917), held that an even narrower religious exemption (see notes 8 and 9 and accompanying text *supra*) did not violate the guarantee of the first amendment. Recent opinions of the Court contain language which indicates that there is at least some doubt as to whether the Court will uphold the Supreme Being test of § 456(j) against first amendment challenges when it chooses to decide the question. See Abington School Dist. v. Schempp, 374 U.S. 203, 217 (1962); Torcaso v. Watkins, 367 U.S. 488 (1961); McGowan v. Maryland, 366 U.S. 420, 442-43 (1961); McCollum v. Board of Educ., 333 U.S. 203, 210-11 (1948); Everson v. Board of Educ., 330 U.S. 1 (1946). These decisions can be read to indicate that restricting the conscientious objector draft exemption to those who are "religious" and also who believe in a "Supreme Being" would be unconstitutional as (1) aiding all religions, or believers as against non-believers; (2) aiding religions based on belief in the existence of God as against those religions founded on different beliefs, grounds seemingly contrary to the prohibitions of *Everson* and *Torcaso.* See Conklin, *Conscientious Objector Provisions: A View in the Light of Torcaso v. Watkins,* 51 GEO. L.J. 252 (1963).

[17] 133 F.2d 703 (2d Cir. 1943). However, it should be noted that the language concerning the definition of religion is no more than dictum, albeit persuasive since later cases have followed it. Kauten's appeal was turned down on procedural grounds. See 133 F.2d at 705-06.

tion."[18] He went on to say that religious belief under the act means "a compelling voice of conscience," or "a response of the individual to an inward mentor, call it conscience or God . . . ."[19] In a later Second Circuit decision, *United States ex. rel. Phillips v. Downer*,[20] absent the procedural infirmity which made the *Kauten* definition dictum, Judge Clark reaffirmed the language of *Kauten* that a "conscientious scruple against war in any form" is a sufficient basis for exemption.[21] In *United States ex. rel. Reel v. Badt*,[22] the Second Circuit again approved the *Kauten* language and held that opposition to war based on humanitarian considerations and not on any obligation to a deity or supernatural power was sufficient to entitle the registrant to a exemption.[23]

The Court of Appeals for the Ninth Circuit rejected the reasoning of the Second Circuit and set forth a second, and narrower, definition of "religion" in *Berman v. United States*.[24] The court said:

> the expression "by reason of religious training and belief" is plain language, and was written into the statute [the 1940 act] for the specific purpose of distinguishing between a conscientious social belief, or a sincere devotion to a high moralistic philosophy, and one based upon an individual's belief in his responsibility to an authority higher and beyond any wordly one.[25]

The court concluded that the registrant's "philosophy and morals and social policy without the concept of deity" does not qualify as "religion" under § 5(g).[26] Religion, according to *Berman*, is "belief in relation to God involving duties superior to those arising

[18] *Id.* at 708.

[19] *Ibid.*

[20] 135 F.2d 521 (2d Cir. 1943).

[21] *Id.* at 524. At the same time, Judge Clark warned that if a stricter rule than was announced in the *Kauten* case is called for, one demanding a belief which cannot be found among the philosophers, but only among religious teachers of recognized organizations, then we are substantially or nearly back to the requirement of the Act of 1917.

[22] 141 F.2d 845 (2d Cir. 1944). Mr. Justice Frankfurter also quoted the *Kauten* language with approval in a dissenting opinion in West Virginia State Board of Education v. Barnette, 319 U.S. 624, 658 (1943).

[23] 141 F.2d at 847.

[24] 156 F.2d 377 (9th Cir.), *cert. denied*, 329 U.S. 795 (1946). It is interesting to note that the same procedural circumstances were present in *Berman* that were present in *Kauten* but the United States Supreme Court, in Falbo v. United States, 320 U.S. 549 (1944), had since decided that they did not prevent the registrant from questioning the decision of the local draft and appeal boards application of the "religious training and belief" requirement.

[25] 156 F.2d at 380.

[26] *Id.* at 381.

from any human relation,"[27] while in *Kauten, Downer,* and *Badt,* a conscientious scruple against war, not necessarily based on any obligation to a deity, qualifies as "religion."

Congress apparently resolved the resultant dichotomy in 1948[28] when it amended the 1940 Selective Training and Service Act. Congress not only adopted the language from the *Berman* case nearly word-for-word,[29] but also expressly cited *Berman.*[30] The Court of Appeals for the Third Circuit accordingly held that an agnostic could not be granted an exemption because his objections could not be based on belief in a relation to a Supreme Being.[31] However, in *United States v. Jakobson,*[32] the Second Circuit said that the Supreme Being clause must be liberally interpreted to avoid constitutional difficulties and continued to substantially follow its pre-1948 views defining religion broadly.[33] Despite the efforts of Congress, the disparity in the definition of religion had been judicially perpetuated. It was in this atmosphere that the Supreme Court decided the *Seeger* case.

In *Seeger,* the Supreme Court purported to construe the words of Congress in order to reach the conclusion that the "legislative intent," as manifested in the language of the act, was to adopt a broad definition of "religion" analogous to that applied in *Kauten.* The Court determined that when Congress added the Supreme Being qualification to the 1940 act it did so only to clarify its original intent.[34] According to the Court, the intent which Congress felt obliged to clarify was not who *was* entitled to military exemption under the statute, but rather who *was not* so entitled.[35] The Court then concluded that the requirement of belief in a relation

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[27] *Id.* at 381, quoting the language of Mr. Justice Hughes in his dissent in United States v. Macintosh, 283 U.S. 605, 633 (1931).

[28] 62 Stat. 612 (1948), 50 U.S.C. App. § 456(j) (1958).

[29] The language of § 456(j) declares that "religious training and belief" is to be defined as "an individual's belief in a relation to a Supreme Being involving duties superior to those arising from any human relation . . . ." This language differs in only one particular from that in *Berman,* 156 F.2d at 381, which in turn had been quoted from United States v. Macintosh, 283 U.S. 605 (1931). The statute contains the words "Supreme Being" in place of the word "God" which appears in *Berman* and *Macintosh.*

[30] S. REP. No. 1268, 80th Cong., 2d Sess. 14 (1948): "This exemption [§ 456(j)] extends to anyone who, because of religious training and belief in his relation to a Supreme Being, is conscientiously opposed to combatant military service or to both combatant and non-combatant military service. (See United States v. Berman, 156 F.2d 377, *certiorari denied,* 329 U.S. 795.)"

[31] United States v. De Lime, 233 F.2d 96 (3d Cir. 1955).

[32] 325 F.2d 409 (2d Cir. 1963). *Jakobson,* as well as Peter v. United States, 324 F.2d 173 (9th Cir. 1964), was decided by the Supreme Court as a companion case to *Seeger.*

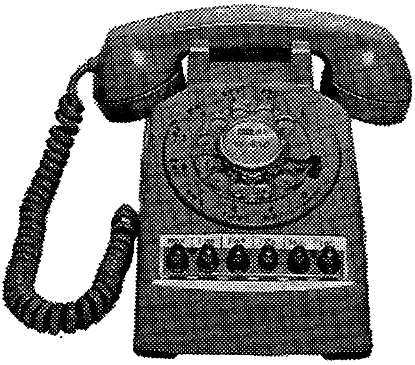
[33] *Id.* at 413-14.

[34] 85 Sup. Ct. at 861.

[35] *Id.* at 860.

to a Supreme Being was not a restrictive test and a conscientious objector could qualify for exemption even though he could *not* avow a belief in a Supreme Being.[36] Consequently, the Supreme Being requirement which caused Seeger's draft board to refuse him an exemption[37] was judicially interpreted out of existence. It seems to be stretching logic to conclude that Congress intended an amendment to clear up an area where there was no disagreement[38]

[36] *Id.* at 854.
[37] 326 F.2d 846, 847 (2d Cir. 1964).
[38] See, *e.g.*, Berman v. United States, 156 F.2d 377 (9th Cir.), *cert. denied*, 329 U.S. 795 (1946); United States v. Kauten, 133 F.2d 703 (2d Cir. 1943). The decisions agreed that exemption must be denied to those whose beliefs were political, social, or philosophical in nature.



and intended to ignore an area where there was a great deal of conflict.[39]

In searching for the proper congressional intent to enable it to avoid the constitutional issues, the Court decided that Congress did not intend to solve any conflict between *Berman* and *Kauten* because "if it [Congress] thought that two clashing interpretations as to what amounted to 'religious belief' had to be resolved, it would have said so somewhere in its deliberations."[40] The Court minimized the fact that Congress in the 1948 amendment used, almost word-for-word,[41] language from the *Berman* opinion.[42] Neither was the Court influenced by the Government's argument that since Congress cited *Berman* in the Senate Report[43] Congress intended to adopt the *Berman* definition of religion. The Court avoided that construction by saying that the citation was for a different purpose: to reaffirm what was not, rather than what was, a sufficient "religious belief" to qualify for exemption.[44] This conclusion, however, is of doubtful validity when the citation is considered in the context in which it was made.[45] The Court also attempted to minimize the import of the citation by saying a mere "parenthetical citation of a case which might stand for a number of things"[46] is outweighed by the "explicit statement of congressional intent"[47] that, "this section reenacts substantially the same provisions as were found in subsection 5(g) of the 1940 act."[48]

Perhaps the most intellectually honest basis for the decision was expounded by Justice Douglas in his concurring opinion in which he said the case was just another instance "where we have gone to extremes to construe an Act of Congress to save it from demise on constitutional grounds."[49] It would be accurate to say that rather than finding what Congress's intent *was*, the Court found what Congress's intent *should have been*.

The test established by the Court in *Seeger* directs the local

[39] *I.e.*, the *Berman - Kauten* conflict as to the definitions of "religion".
[40] 85 Sup. Ct. at 860.
[41] See *supra* note 29.
[42] 85 Sup. Ct. at 859. The court did this by saying that the language used came originally from United States v. Macintosh, 283 U.S. 605 (1931), an earlier opinion by Mr. Chief Justice Hughes which the Court pointed out "supports our interpretation." 85 Sup. Ct. at 860.
[43] S. REP. No. 1268, 80th Cong., 2d Sess. 14 (1948).
[44] 85 Sup. Ct. at 860.
[45] *Supra* note 30.
[46] 85 Sup. Ct. at 859.
[47] *Ibid.*
[48] 85 Sup. Ct. at 857, quoting from S. REP. No. 1268, 80th Cong., 2d Sess. 14 (1948).
[49] 85 Sup. Ct. at 865. See Ullman v. United States, 350 U.S. 422, 433 (1956); United States v. Rumely, 345 U.S. 41, 47 (1953); Ashwander v. TVA, 297 U.S. 288, 341, 348 (1936); Crowell v. Benson, 285 U.S. 22, 62 (1932).

draft boards and courts to "decide whether the beliefs professed by a registrant are [1] sincerely held and [2] whether they are, in his own scheme of things, religious."[50] A belief is "religious" when it "occupies in the life of its possessor a place parallel to that filled by the God of those admittedly qualifying for the exemption . . . ."[51] These beliefs may be either externally or internally derived.[52] The Court also gave approval to the portion of the act which says that objection cannot be based on a "merely personal moral code,"[53] although its application may be limited by the Court's statement that there can be no distinction "between externally and internally derived beliefs."[54]

In spite of the broad interpretation the Supreme Court has given § 456(j), two things are apparent. First, the Court is still faced with the potential issue of whether § 456(j) violates the establishment clause of the first amendment, but that question can be properly raised only by an atheist.[55] If the statute is held to be unconstitutional on that ground, Congress will have to draft another exemption and avoid conditioning it on "religious beliefs." Failure to provide *any* exemption could in turn be challenged as a violation of the first amendment right to the free exercise of religion. Second, those who must administer the act — the draft boards and the courts — still must make two difficult determinations from rather nebulous standards: (1) Is the applicant sincere? (2) Are the applicant's objections based on a "religious belief" as defined in *Seeger?* While the Court's decision in *Seeger* broadened the definition of "religion," it certainly did not make the standards for exemption any clearer. Resolution of both the constitutional and administrative problems presented by § 6(j) of the Universal Military Training and Service Act could be realized if Congress would grant a military service exemption to all those persons who sincerely object to participation in war in any form. After *Seeger,* the next step in the evolution of the conscientious objector exemption should be taken by the Legislature. However, it is doubtful that Congress will choose to act.[56]

Richard M. Koon

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[50] 85 Sup. Ct. at 863.
[51] *Id.* at 859.
[52] *Id.* at 864.
[53] *Ibid.*
[54] *Ibid.*
[55] 85 Sup. Ct. at 858.
[56] The American Civil Liberties Union urged a somewhat similar non-religious exemption in 1940 which was rejected by Congress. *Hearings on S. 4164 Before the Senate Committee on Military Affairs,* 76th Cong., 3d Sess. at 308 (1949).

BOOK REVIEW

THE RIGHT OF ESTABLISHMENT IN THE COMMON MARKET. By Dr. Ulrich Everling. Chicago: Commerce Clearing House, Inc. Pp. xv, 219. $15.00.

This book, a translation from German of an identically entitled study written by Dr. Ulrich Everling — Ministerialrat in the Ministry of Economics of the Federal Republic of Germany — presents the reader with a detailed analysis of the provisions of the Rome Treaty relating to the right of individuals and companies of the Member States of the European Economic Community to carry on business activities in the Common Market. Freedom of establishment involves the right to commence and conduct non-wage-earning activities (selbstandige Erwerbstatigkeiten, activites non salariees) which cover not only commercial and industrial operations (including banking, insurance, transport, agriculture, fishing, etc.) but also activities of individuals engaged in the liberal professions (lawyers, doctors, accountants and so on).

The author emphasizes that the provisions on the right of establishment must be seen in the over-all context of the basic objectives of the Common Market which include increased mobility of the factors of production through the elimination of customs and trade barriers, enabling nationals and companies to pursue independent economic activities anywhere in the Community, either in the form of an establishment or through services. Since it is through the free interchange of capital and labor that the right of establishment can become fully effective and meaningful, the various measures — as, for instance, the mutual recognition of diplomas and other evidences of qualification—for the elimination of discriminatory restrictions on free movement and for coordination assume particular significance. Apart from its economic importance, the right of establishment, by promoting a general feeling of solidarity among the peoples of the Community, may be expected to contribute to a strengthening of their political ties.

While the right of establishment is accorded only to individuals and companies of the Community and, therefore, is primarily of interest to them, this English edition also contains in its "Introduction" a brief but valuable discussion of some of the implications for nationals and companies of non-Member States which may be read with benefit by businessmen and professionals having contacts with the Common Market countries.

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BOOKS RECEIVED

ARREST: THE DECISION TO TAKE A SUSPECT INTO CUSTODY. By Wayne R. LaFave. Boston: Little, Brown and Co. 1965. Pp. xxxiv, 540. $10.00. This is the first publication resulting from studies on the administration of criminal justice sponsored by the American Bar Foundation. Current practices are examined in order to answer such questions as: Who makes the decision to arrest? How is it controlled in order to assure consistency and fairness? Why do the police at times act other than in strict conformity with existing laws? The study examines each problem which relates to the arrest decision.

AUTOMOBILE ACCIDENT COSTS AND PAYMENTS: STUDIES IN THE ECONOMICS OF INJURY REPARATION. Edited by Alfred F. Conrad, James N. Morgan, Robert W. Pratt, Jr., Charles E. Voltz, and Robert L. Bombaugh. Ann Arbor: University of Michigan Press. 1964. Pp. xxviii, 506. $12.50. This book is the first comprehensive study of what happens to automobile victims after their injury. On the basis of extensive field surveys, the authors report on the amount of money that injury victims lose, how much they are paid, the success of damage suits settled in and out of court, and many other related matters.

INTERNATIONAL LICENSING AGREEMENTS. Edited by Gotz M. Pollzien and George B. Bronfen. New York: Bobbs-Merrill. 1965. Pp. xxxv, 426. $22.50. This new book consists of comprehensive reports on national licensing laws in 22 foreign and North American countries, and explores supra-national rules of the European Common Market. Each of the 22 reports is written by a distinguished specialist in his own country.

JUSTICE RUTLEDGE AND THE BRIGHT CONSTELLATION. By Fowler V. Harper. New York: Bobbs-Merrill. 1965. Pp. xxv, 406. $6.95. A searching biography of a man who considered himself an associate rather than an Associate Justice, and his commitment to the Bill of Rights. Special emphasis is placed on Rutledge's years on the Supreme Court, and more particularly on his attitude and judicial pronouncements on the first eight amendments to the Constitution.

MORALITY OF LAW, THE. By Lon L. Fuller. New Haven: Yale University Press. 1964. Pp. vii, 202. $5.00. Mr. Fuller probes the relation of law to morality and suggests that the dilemmas posed by the association are not easily solved because the internal morality of law is not independent of the power of law but an essential condition of that power.

REGISTRATION AND REGULATION OF BROKERS AND DEALERS. By Ezra Weiss. Washington: Bureau of National Affairs, Inc. 1965. Pp. xxvii, 363. $17.50. An up-to-date handbook and reference guide which explains the rules, regulations, qualifications, and responsibilities governing: (1) the entrance of persons into the securities business, and (2) the manner in which registered brokers and dealers must operate in order to comply with SEC requirements.

STANDARDS OF AMERICAN LEGISLATION. By Ernst Freund. Chicago: The University of Chicago Press. 1965. Pp. li, 327. Cloth: $5.50. Paper: $2.45. In this second edition of his book, Mr Freund suggests the possibility of supplementing the established doctrine of ex post facto enforcement of legislative norms through review and negation with a system of positive principles which should guide and control the enactment of statutes.

STATUTE MAKING. By Armand B. Coigne. New York: CCH. 1965. Pp. 293. $12.50. The history of a legislative bill from inception to final passage or defeat is the subject of this book. The author, assuming no prior knowledge on the part of the reader, discusses definitively the many processes involved in enacting statutes at federal, state, and local levels of government. This second edition incorporates statutory and constitutional changes which have occurred since 1948, when the first edition appeared.

BAR BRIEFS
OPINION NO. 34 OF THE ETHICS COMMITTEE OF THE COLORADO BAR ASSOCIATION ADOPTED MARCH 27, 1965

SYLLABUS

It is improper for a lawyer in a personal injury case to advance living expenses to or for the benefit of his injured client.

FACTS

A lawyer handles personal injury cases. He desires to advance funds for living expenses to his injured clients, with the understanding that he will be reimbursed at the time the case is concluded and that such reimbursement will be in addition to any fee for professional services. The Committee has been asked whether such a practice violates the Canons of Ethics.

OPINION

The Committee is of the opinion that such a practice clearly violates Canons 6 and 10. Canon 42 outlines the limits which must be observed and clearly does not authorize this practice.

The principal objection to this practice is that it amounts to the purchase by the lawyer of an interest in the litigation. This is clearly prohibited by Canon 10. This is true whether or not the client's agreement to reimburse the lawyer is contingent on recovery. A client whose assets are so meager that he requires advances from his counsel to live is unlikely to have any realistic chance of repaying such advances if there is no recovery on his claim.

This practice, by giving the lawyer an additional stake in the case beyond his fees, places the attorney in a situation where his own personal pecuniary interests may well conflict with the best interests of his client and make it impossible for him to represent the client with the undivided fidelity required by Canon 6. While this conflict exists already with respect to counsel fees (particularly in contingent fee cases), we feel that it should *not* be extended to a situation where the lawyer seeks not only compensation but reimbursement.

The justification usually given in support of the practice of advancing living expenses is that it eliminates the urgency of an injured person's need for funds as a factor to be considered in disposing of the case, either by settlement or by trial, and tends to prevent the disparity in economic status usually present in personal injury cases from being a factor in the case. The Committee recognizes that such economic disparity exists in many cases, that it ought not to affect the outcome of the cases, and that, unfortunately, it sometimes does. The Committee is of the opinion, however, that the practice of having a lawyer advance living costs is not an appropriate nor professionally proper method of resolving the problem. The law is a profession and those engaging therein must use all of the skills of that profession on behalf of those who seek their counsel. Money lending is not one of those professional skills. A remedy for the problem created by economic disparity of litigants must be sought in the proper use of professional skills.

This question has been considered elsewhere. In Opinion 288 by the ABA Ethics Committee, 41 ABA Journal 33, the Committee concluded that such a practice was improper. A like conclusion was reached recently by the Ohio Supreme Court in *Mahoning County Bar Ass'n v. Ruffalo,* 176 Ohio 263, 199 N.E.2d 396 (1964). This Committee agrees with these authorities and, like them, is not persuaded by *People v. McCallum,* 341 Ill. 578, 173 N.E. 827 (1930), in which the Illinois Supreme Court reaches a different conclusion.

Finally, it should be pointed out that the practice, if publicized, constitutes a holding out by the lawyer of an improper inducement to clients to employ him, in addition to the assurance of performing legal services for the client (see Canon 27).